The Impact of the Russian Legal Climate

on

Foreign Investors

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ABSTRACT

There is a consensus in the law and development field and international policy circles that a Theoretically Ideal Legal Climate is necessary to attract foreign investment into an emerging economy. This research study analyses and attempts to build on this 'Dominant Theory' in the context of Russia.

The Dominant Theory has little direct empirical support: the methods that are most often used to assert that law as a determinant of foreign investment are inappropriate to the task, and the findings of such studies are inconsistent and unconvincing. Further, the studies that purport to assert the importance of a Theoretically Ideal Legal Climate to foreign investors leave three important questions unanswered:

- How do foreign investors perceive the host legal climate before investing?
- Why do they invest in countries that lack a Theoretically Ideal Legal Climate?
- What factors affect the importance that foreign investors attach to host legal climates?

A range of existing research provides preliminary answers to these questions, suggesting that the Dominant Theory is not entirely accurate. They form the basis of two hypotheses. Interviews of foreign investors and their advisors in London and Moscow are carried out to address the research agenda.

The evidence verify the hypotheses. While foreign investors would prefer a Theoretically Ideal Legal Climate, and welcome improvements in the quality of the Russian legal climate, it is clear that a notable faction of them do not conform to the Dominant Theory. First, according to the interviewees, the quality of Russia's legal climate does determine whether investors choose to invest there or not. Second, foreign investors can operate successfully in the absence of a Theoretically Ideal Legal Climate. Finally, the impact of the Russia's legal climate depends significantly on the characteristics of the investor and nature of the investment.

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Chapter One

Introduction

1 The Ideal Legal Climate for Foreign Investment

1.1 Overview

This work is an assessment of the importance of a 'theoretically ideal' legal climate for the attraction and support of foreign investors into Russia. It will be demonstrated shortly that there is a widely held view in the development field, as well as in international policy circles, that a theoretically ideal legal climate is necessary for the creation of an environment that is attractive to foreign investors. This belief, following the work for Perry-Kessaris shall be referred to here as the 'Dominant Theory'.[1] It is apparent, however, that this Theory lacks a robust empirical base, and has various limitations.[2] Using the Dominant Theory and its limitations as a starting point, the main aim of this study is the following: first, to assess the importance of the overall quality of Russia's legal climate to the attraction and support of foreign investors around 2004; second, to develop a more accurate understanding and explanation of the relationship between foreign investors and host legal climates.

The notion of a 'theoretically ideal legal climate' has its roots in the rule of law. However, the 'rule of law' is a term which carries great intellectual 'baggage, and is prone to misunderstanding. Brian Tamanaha has recently devoted a book to examining the emergence and meaning of the concept.[3] According to Tamanaha, the rule of law is an "exceedingly elusive notion."[4] Even among political and legal theorists there is no accord as to its meaning, leading one to remark that "there are almost as many concepts of the rule of law as there are people defending it."[5] Within the law and development field, scholars such as Carothers and Upham are critical of

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1 See Perry 2001.
2 Chapters Three and Four review evidence available.
3 Tamanaha 2004.
4 Tamanaha 2004, 3.
5 Taiwo 1999 cited in Tamanaha 2004, 3.

the use of the term.[6] Acknowledging the criticism, one the arch-proponents of the rule of law, the World Bank has conceded that ambiguous rhetoric should be set aside.[7] Fortunately, this is not a debate we need to be drawn into, for in this field of study, the concept under examination is sufficiently clear.

The present study is not concerned with examining the rule of law in the familiar sense, as a political ideal whose history is ancient, but whose substance is still contested. Instead, this thesis is concerned with a concept that is inspired by it, but which is in principle apolitical and, further, whose application is much more specific. The concept we are concerned with is a notion tailored to the goal of economic development, and in particular, the attraction of foreign investment. To avoid confusion, from this point forward, a Theoretically Ideal Legal Climate to support foreign investors, or, for brevity, a Theoretically Ideal Legal Climate, shall be used to refer to the model under examination in this thesis.[8] The term the 'rule of law' will be used to refer to the broader, political ideal, where the subject arises.

1.2 The 'Dominant Theory': Claims about the Importance of a Theoretically Ideal Legal Climate for Foreign Investors

The Dominant Theory is an argument that asserts that the quality of the legal climate is an important determinant of foreign investment, and therefore that a Theoretically Ideal Legal Climate is required to attract foreign investment into countries with weak legal climates, like Russia. At the heart of the Dominant Theory is the concept of a legal climate that is best suited to economic development by serving the needs of

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6 See for example, Carothers 1998, Upham 2002.

7 World Bank "A Theoretically Ideal Legal Climate as a Goal of Development Policy" internet site, visited on 14/8/05.

8 Perry-Kessaris develops the concept of an "Ideal Legal Paradigm" for foreign investment, against which she assesses Sri Lanka's legal climate. The "Ideal Paradigm" is substantially the same concept as the Theoretically Ideal Legal Climate. However, I have not borrowed the term as it reflects a slightly out-dated and narrow World Bank definition of the procedural attributes of an ideal legal climate. See Perry 2001.

domestic and foreign investors. While there is no single written definition of a Theoretically Ideal Legal Climate, its advocates have a common, shared idea of the attributes of such a legal climate. As the extracts below show, a Theoretically Ideal Legal Climate is one which provides an unspecified yet satisfactory degree of certainty and efficiency in the enforcement of investors' rights. A full analysis of the theoretical basis and features of the Theoretically Ideal Legal Climate is undertaken in Chapter Two.

This study is not questioning the general desirability of a Theoretically Ideal Legal Climate, for instance whether it is beneficial to foreign investment, or whether foreign investors tend to prefer such climates. Instead, using the Dominant Theory as a starting point this work aims to examine the impact of the quality of Russia's legal climate on foreign investors at two stages: during the decision to invest, and during operations in Russia.

This subsection establishes the existence of a widely held and frequently repeated belief in the importance of a Theoretically Ideal Legal Climate to foreign investors, with a particular focus on Russia. To start off, the conviction about the need for legal reform to establish a Theoretically Ideal Legal Climate, which in turn is expected to attract investment into transition economies, is summarised clearly in the following extract from a World Bank publication:

> "The massive move by developing and transition countries toward market economies necessitated the adoption of strategies for the encouragement of private investment, domestic and foreign. Naturally, there was a general realization that such an objective could not be achieved without modifying and, sometimes, completely overhauling the legal and institutional framework and firmly establishing the rule of law, thereby creating the necessary climate of stability and predictability."[9]

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9 World Bank 1999, 1-2.

It is also important to make it explicit that the Dominant Theory is believed to reflect the role of law in the decision to invest in a foreign country:

> *"some of the most important factors considered by investors as they decide on investment location* are a predictable and non-discriminatory regulatory environment and an absence of undue administrative impediments to business more generally...The most effective action by host country authorities to meet investors' expectations is: safeguarding public sector transparency, including an impartial system of courts and law enforcement ..."[10] [Emphasis added]

Since a Theoretically Ideal Legal Climate is considered important to foreign investors, it is assumed that failure to establish a Theoretically Ideal Legal Climate will deter foreign investment. In 2002, the OECD held an investment conference on attracting FDI into Russia. In one of the related publications, the organization argues that failure to develop a level playing field and the rule of law will "certainly discourage" FDI.[11] An earlier review of the Russian investment climate by the same organization provides more detail. In the review, the OECD sought to identify factors impeding foreign and domestic investment. Declaring that the legal climate was among the obstacles, its position on the legal environment is summarised as follows:

> "Much has been said above, both in general and specific terms regarding the need to deal with crime, corruption, lack of security of property rights and of enforcement of contracts and judgments in dispute resolution so as to improve the business climate for foreign and domestic investors."[12]

Since it is held that countries like Russia currently lack a Theoretically Ideal Legal Climate and that one needs to be established, advocates of the Dominant Theory call for legal reforms, as the first extract showed. The World Bank therefore prescribes

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10 OECD 2003, 7.
11 OECD 2002a, 9.
12 OECD 2001, 31.

legal reform as a 'policy solution' to attracting FDI. For example, on its Private Sector Development website, the Bank advises that:

> "An uncertain and insecure regulatory environment is a major deterrent to investment and entrepreneurship...Policymakers should ensure that laws and regulations are consistent with the needs of a free market, contracts and property rights are enforced, due process is efficient in correcting abuses, and legal requirements are transparent and accessible."[13]

The Foreign Investment Advisory Service is an affiliate of the World Bank Group which dispenses advice to developing country governments about how to attract foreign investment. In a 1997 publication, a transparent and non-discretionary legal climate is classified as an "indispensable precondition" for encouraging FDI.[14] The author goes on to suggest that establishing the rule of law is one of the ways in which Russia could become a much more attractive investment destination.[15] Finally, at a foreign investment conference in Massachusetts in 1999, the Deputy US Treasury Secretary declared that judicial reform should be Russia's top priority.[16]

What is referred to in the present work as the Dominant Theory is an expression, in the context of foreign investment, of a widely held view in the law and development field of the role of law in development generally. For example, the former President of the World Bank asserts that:

> "Legal and judicial systems that work effectively, efficiently, and fairly are the backbone of national economic and social development. National and international investors need to know that the rules they operate under will be expeditiously and fairly enforced."[17]

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13 World Bank, 'Private Sector Development' internet site, page on 'Making Laws and Regulations More Predictable', visited on 14/8/05.

14 Michalet 1997, 3.

15 Michalet 1997, 26.

16 Reported in Hendrix 2001, 94.

17 Quoted in Upham 2002, 10. Original document no longer available.

The President of the EBRD, in a speech to the Foreign Investment Advisory Council of Russia, strikes a similar tone:

> "The sound implementation of the rule of law is crucial for the country's investment climate ..."[18]

And finally, the General Counsel of the World Bank, on a speech on legal reform in transition countries:

> "Thus, investors need the rule of law. They need transparent and equitable laws, with access to justice and due process, and enforceable contracts."[19]

The extracts above are representative of the most common belief, amongst those concerned with the subject, about the impact of host legal climates on foreign investment; hence the term "The Dominant Theory". Moreover, the Theory counts among its advocates a near consensus of multinational institutions and policy makers, and as Chapter Three will show, further support from a range of academics, research organisations and foreign investment organisations. The Theory sounds convincing, logical and virtually self-evident; in fact, it seems so obvious that it is almost unchallenged, and rarely questioned. There would be little to scrutinise were the Theory based on research on the role of law in foreign investment decisions, or the legal practises of foreign investors in weak legal climates. But they are not based on such evidence. Instead, as the former President of the World Bank makes clear, the Dominant Theory stems from a belief in the role of law in economic development more generally.

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18 Lemierre 2003.

19 Danino 2003.

2 Definition of Terms

2.1 Foreign Direct Investment

A foreign direct investment (FDI) has a number of distinguishing characteristics. It is an investment that moves from one state, the home state, to the another, the host state. As opposed to indirect investment (e.g. portfolio investment), the investment remains within the same economic entity.[20] FDI also implies a long-term interest in the investment. FDI further implies that the foreign investor exerts a "significant degree of influence" on the management of the firm resident in the host state.[21]

2.2 Legal Systems

This study defines legal systems in the same way as Perry-Kessaris' 2001 work on the Sri Lankan legal system as a determinant of foreign investment there. In order to capture the entirety of the relationship between foreign investor and host legal system, she defines the legal system to encompass: the state institutions that govern the behaviour of economic actors; the laws and regulations according to which economic actors operate; and the manner in which these laws and regulations are applied. State institutions include judicial institutions, as well as the bureaucracy and politicians in their capacity as law-makers and law-enforcers.[22] The study considers only those laws and regulations that seek to regulate economic behaviour.

In addition to the formal legal system, this study is also interested in the role of informal institutions. North defined institutions as "the rules of the game in a society or, more formally, the humanly devised constraints that shape human interaction."[23] Informal institutions cannot, however, be defined as precisely as formal ones.[24] The difference between them is "one of degree. Envision a continuum of taboos, customs

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20 Perry 2001, 13.
21 UNCTAD 2003, 231.
22 Perry 2001, 24.
23 North 1990, 3.
24 North 1997, 4.

and traditions at one end to written constitutions at the other."[25] Informal institutions are relevant to the present study, above all, because they help to facilitate economic exchange, where formal - that is state institutions, do not function or are inefficient.[26] They therefore help to explain how economic actors might do business in the absence of a Theoretically Ideal Legal Climate.

It is not direct formal restrictions on foreign ownership that are thought to be the main deterrent to foreign investment in Russia today, in fact, the country has made great strides in opening its economy to foreign investment.[27] During most of the Soviet period foreign investment was extremely limited as foreign investment was, in principle, prohibited. A number of developments opened the way for foreign investment in Russia. After the dissolution of the Soviet Union in late December 1991, there was a swift succession of foreign investment legislation. Marking a 180 degree change in policy, many formal obstacles to investment were promptly removed, and Russia embraced a fundamental freedom to invest, subject to certain limitations.[28] The development of market institutions were also essential in this process. The adoption of a new Constitution in 1993 protected property rights, including those of foreign investors. The Civil Code, introduced in 1995, established the principles of commercial relations. Russia's foreign investment laws and the policies that led up to them will be reviewed in detail in Chapter Six.

Following the approach of the World Bank's investment climate surveys and the work of Amanda Perry-Kessaris, this study researches foreign investors' perceptions and experiences of the general features of the Russian legal climate and institutions, not aspects of particular Russian commercial legislation. First of all, there are a host of legal scholars and commentators who have already reviewed existing Russian commercial law, and as in many other jurisdictions, regularly report on legislative

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25 North 1990, 46.
26 World Bank 2002b, 171-173.
27 OECD 2004, 12
28 Hogan & Hartson LLP 2006

developments in the Federation.[29] This aside, the use of foreign investor perceptions is rooted in more fundamental methodological reasoning. The needs of investors are central to the World Bank's approach to governance; indeed, their assessments of investment environments, including legal climates, as well as those of many other organisations, are based on the perceptions of domestic and foreign businesses.[30] Also, the model of a Theoretically Ideal Legal Climate describes the general attributes of legal institutions and the characteristics of laws in broad terms – it does not prescribe any substantive content for laws. It is this broader perspective that is needed to assess the overall impact of the Russian legal climate. It will be left to future studies to undertake the important task of researching the impact of specific bodies of commercial law on foreign investors in Russia.

2.3 What is a Determinant of Foreign Investment?

The idea that a particular type of legal system is a 'requirement' for the attraction of foreign investors prompts us to consider how we define a determinant of FDI. The Dominant Theory implies that a determinant of FDI is not simply any factor that may indirectly contribute to foreign investment flows over the long term, but a factor that directly affects foreign investment *decisions*. This interpretation is supported by a wide range of studies which expressly view foreign investment determination in terms of foreign investors' decisions, though critically, they rarely present direct evidence about the decision process itself.[31]

The Dominant Theory takes a clear position about the impact of the law on the foreign investment decision. This view stems from the primacy that traditional law and economics bestows on formal legal systems for providing a suitable business

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29 The most comprehensive review of Russian legislation can be found in Butler 2003. Twice a year the EBRD publishes the journal, *Law in Transition*, which covers legislative development across the region. Private law firms also publish regular analysis of Russian legislative developments, for example, Ernst & Young's *Russia Law Brief*, and Baker & McKenzie's *Doing Business in the Russian Federation*.

30 See Chapter Two, subsection 1.1

31 Bevan and Estrin 2000, 16; Brunetti *et al.* 1997, 19; Fabry and Zeghni 2002; Hewko 2002, 9; Lankes and Venables 1997, 557; Perry 2001, 14; Resmini 2001, 678.

environment. The point to keep in mind is that the Dominant Theory's expectation of how foreign investors are expected to perceive and respond to the quality of host legal climates is derived from this general belief, rather than from dedicated research on how foreign investors *actually* make their investment decisions.[32]

3 The Limitations of the Dominant Theory

In Chapter Two, the theoretical foundations of the Dominant Theory are examined. It is shown that belief in the importance of law for foreign investors is rooted in traditional law and economics. To best support investors, legal climates should provide efficiency and predictability. The blueprint for the Theoretically Ideal Legal Climate, that can provide these features is then laid out. Chapter Three then assesses the evidence on law as a determinant of foreign investment. Research that might be considered to support the Dominant Theory suffers both from methodological limitations, as well as in the inconsistency of the findings themselves. Chapter Four moves on to consider a wide array of evidence that suggests that law is not so important to foreign investors.

The assessments of existing theory and research in Chapters Three and Four demonstrate that the Dominant Theory has three main limitations, which are outlined briefly in the following subsection. These limitations show that the Dominant Theory does not accurately capture the impact of the law on foreign investors, neither at the pre-investment decision making stage, nor during operations. The fieldwork is designed primarily to address these limitations, which are brought to attention in Chapters Three and Four. These limitations serve as a starting point towards a more complete understanding of the impact of the Russian legal climate on foreign investors.

Before moving on, it is important to be very clear about the aim of this research study. The Dominant Theory is emphatic about the necessity of a Theoretically Ideal

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32 Perry-Kessaris 2003, 650.

Legal Climate for the attraction and support of foreign investors. It must be stressed that, in questioning the established view, this study does not intend to suggest that the quality of host legal climates are irrelevant to foreign investors; nor that legal climates such as Russia's are not in need of reform; nor that foreign investors would not welcome improvements in the country's legal climate; nor is it being suggested that the Theoretically Ideal Legal Climate is unattractive to foreign investors. It is hard to argue against the idea that a Theoretically Ideal Legal Climate, or in the words of the World Bank - "an effective system of property, contracts...and other elements of a comprehensive legal system that are effectively, impartially, and cleanly administered by a well-functioning, impartial and honest judicial and legal system"[33] - is good for foreign investment.[34] This study does not question what investors might want under ideal circumstances, but concerns itself with contributing to our understanding of the relationship between foreign investors and host legal climates in real world legal climates.

Rather than to suggest that the Dominant Theory is 'wrong', the approach of this study is to recognise the existence of a faction of investors who do not conform to the Dominant Theory, and who we can term as being 'less sensitive' to the quality of host legal climates. By addressing the limitations of the Dominant Theory, this study attempts to present a more accurate and complete picture of the relationship between Russia's legal climate and foreign investors circa 2004. Finally, the analysis of the Dominant Theory is rounded off with an examination the Theory's prescription of legal reform as a means to attracting foreign investment into Russia.

3.1 Hypothesis One: The Alleged Necessity of a Theoretically Ideal Legal Climate

The primary hypothesis questions the Dominant Theory directly:

> "A Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia."

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33 Wolfensohn 1999, 10

34 Upham 2002, 10

There are two main reasons why this hypothesis has been drawn up. First, to assert that law is a determinant of foreign investment implies that potential investors refer to accurate information about the legal climates of potential hosts when they are choosing the investment destination. But as Chapter Four will show, there is evidence that suggests that some potential foreign investors may not have accurate information about host legal climates when choosing a host, especially in Russia's case. Remarkably, there is barely any research into this vital point;[35] it is simply presumed that they are well informed. The role of foreign firms' perceptions of the Russian legal climate is therefore a natural starting point for the fieldwork in the present study.

The second reason for Hypothesis One is that a Theoretically Ideal Legal Climate may simply not be as important to some foreign investors as the advocates of the Dominant Theory consider it to be. The literature presented in Chapter Four shows that there is good reason to question whether all foreign investors actually need polished legal climates in order to invest and operate successfully. First of all, foreign investors may overlook the quality of the legal climate if non-legal factors are more important, and take precedence in the decision to invest. Further, foreign investors may in fact be able to do business successfully in countries that lack a Theoretically Ideal Legal Climate, for example by using informal institutions or bribery when the official legal system does not meet their needs. The Dominant Theory and the work supporting it is limited because it does not give sufficient consideration to these possibilities. The present work intends therefore to address how foreign investors respond to the Russian legal climate both during the investment process and during their operations in the country.

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35 In fact, the only study to examine this issue is Perry 2001. Her findings are summarised in Chapter Three, Section 2. Her findings do not verify this presumption.

3.2 Hypothesis Two: The Alleged Homogeneity of Foreign Investors

The third weakness of the Dominant Theory is that it does not take into account differences in the attitudes of foreign investors towards the legal climate. The Dominant Theory treats foreign investors as a uniform group. Challenging this, Hypothesis Two is that:

> "Foreign investors' perceptions of the Russian legal climate depend on their firm characteristics."

Hypothesis Two is supported by growing evidence that the relationship between firms and the law varies according to the firm's characteristics. Most of the evidence relates to domestic firms, but there is also a notable body of research on the effect of foreign investors' characteristics such as their size, export-orientation and ownership.[36]

We are therefore prompted to examine whether the impact of the legal climate, both in the decision to invest and during operations, differs between foreign investors. Evidence of consistent differences in attitudes towards the legal climate shows that a certain faction of foreign investors do not conform to the Dominant Theory. This would suggest that the Theory oversimplifies the role of law.

3.3 Summary

The Dominant Theory bases the model of the relationship between host legal climates and foreign investors on the alleged importance of a Theoretically Ideal Legal Climate for economic development. Advocates of the Theory insist that the quality of the host legal climate is one of the foremost concerns of foreign investors, both in the decision to invest, and also during operations in Russia. While existing research in the field appears to support the Dominant Theory, both the research methods and findings have significant shortcomings. Also, there is a notable body of

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36 This evidence is presented in Chapter Four, Section 4.

evidence that suggests that a Theoretically Ideal Legal Climate is not of primary importance foreign investors.

It is not the intention of this work to allege that there is no truth in the Dominant Theory. The overall argument of this thesis is that the Dominant Theory overstates the importance of the quality of the host legal climate, and in doing so fails to account for those investors who are less sensitive to the quality of host legal climates. Thus it provides a *partial* framework for understanding the impact of the legal climate on foreign investors in countries like Russia. The present work highlights and responds to the limitations of the Dominant Theory with the aim of contributing to a more complete understanding of the impact of the Russian legal climate on foreign investors around 2004. It does this specifically by looking at:

1. The role of perceptions of the Russian legal climate in the decision to invest.
2. The impact of the Russian legal climate on foreign investors in the country.
3. The effect of firm characteristics on perceptions of the Russian legal climate

Finally, there is a significant facet of the Dominant Theory which exists outside of the short-term context of foreign investment decisions and activities. As the quotations in earlier demonstrated, advocates of the Theory frequently prescribe legal reform as a solution to foreign investment attraction. Indeed, to do so is the logical consequence of arguing that a Theoretically Ideal Legal Climate is essential to attracting foreign investment. This thesis considers the merits such a prescription, assessing the challenge of establishing the Theoretically Ideal Legal Climate in Russia. We shall return to this issue shortly.

To address the research agenda, the present work employs semi-structured interviews with foreign investors and their advisors, both in London and Moscow. Semi-structured interviews are preferred over other research methods because they provide the depth of insight and flexibility that is required to address the research agenda. Chapter Five first describes Russia's legal heritage and then moves on to

assess the present day legal climate using existing sources as well as an analysis, based on World Bank survey data, of foreign investors' perceptions on the Russian legal climate; the data analysis is original to this study. Chapter Seven presents the research methodology and interview questions. The interview findings themselves are presented in Chapter Eight.

4 Why Research Foreign Investors in Russia?

Examining a Theoretically Ideal Legal Climate from the perspective of foreign investors in Russia is particularly appropriate. The collapse of Communism is said to have represented one of the most important economic transitions of all time.[37] Legal reform has been an integral part of the transformation, and since 1989 transition countries have been the most active in legal reform projects.[38] This Section shows that a vast amount of money has been spent on legal reform, an effort which has to a significant extent been driven by foreign investors and the desire to attract them. Further, the focus on Russia is warranted by the its failure to attract FDI and establish a Theoretically Ideal Legal Climate. In fact, the sheer difficulty of establishing a Theoretically Ideal Legal Climate raises doubt over the merits of prescribing it as a solution to foreign investment attraction.

4.1 The Importance of Foreign Investors to the Legal Reform Agenda

The World Bank, which is the foremost proponent of the Dominant Theory,[39] has for a long time been concerned with legal reform for the sake of attracting foreign investors. Enshrined in Article I of the World Bank's Articles of Agreement, is the

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37 Stiglitz 2002, 133.

38 Carothers 1998, 4.

39 Three of the extracts in support of the Dominant Theory in Section 1.2 were from the World Bank; two more were published by its partner agencies, the European Bank for Reconstruction and Development and the Foreign Investment Advisory Service. Further evidence of its propagation of a Theoretically Ideal Legal Climate can be found in regular publications such as the *World Development Report* (for example 2002, 2005). See also the 'Legal and Judicial Reform' pages on the Bank's website.

objective of promoting private foreign investment.[40] Three of its constituent organisations are dedicated in one way or another to the promotion and support of foreign investment: the International Centre for the Settlement of Investment Disputes, the Multilateral Investment Guarantee Agency (MIGA), and the Foreign Investment Advisory Service (FIAS) of the International Financial Corporation.

In the World Bank's view, foreign investors are the main clients for legal reforms.[41] The creation of an investment environment supportive to foreign investors has always been one of the aims of legal reform. With the demise of state socialism and ascendancy of market capitalism, private sector development (PSD) emerged as one of the World Bank's priorities. From early on, the legal and regulatory framework was considered vital to PSD, with the promotion of foreign investment integral to its aims. The aforementioned foreign investment agencies collaborated with the Bank in shaping the PSD agenda.[42]

Representatives of foreign investors have also been influential in shaping the substance of legal reforms. For example, according to the Bank, FIAS was involved in setting the agenda for legal and judicial reform in the transition region.[43] Between 1994 and 2004, the organisation was involved in fifteen projects in Russia alone, relating *inter alia* to investment laws, foreign investment laws and policies, and administrative barriers.[44] The union of the foreign investment and legal reform agendas is best demonstrated by the EBRD's curious position as both a leading figure in legal reform efforts and its status as the region's largest single investor. In Russia, the Foreign Investment Advisory Council, a gathering of large multinational foreign investors chaired by the Russian Prime Minister, advises on legal and regulatory changes.[45] Other foreign investment associations, such as the American Chamber of

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40 World Bank Articles of Agreement, Article I (ii)
41 McAuslan 2004, 65.
42 Shihata 1991, 207 and 257-269.
43 Gupta *et al.* 2002, 7.
44 FIAS Internet Site, Projects Page.
45 FIAC Internet Site.

Commerce also lobby for reforms, for example in intellectual property rights.[46] It should be kept in mind that foreign investors' interests may not always coincide with that of other investors or society as a whole.[47]

4.2 Legal Reform and World Bank Lending

It is hard to overstate the importance attributed to legal reform within the orthodoxy of law and development. Most importantly, there is a widely held belief that sustainable economic development cannot occur in the absence of the rule of law.[48] Perhaps owing to this belief, by the late 1990's roughly 78% of loans made by the international financial institutions were conditioned on the implementation of legal reform projects.[49] In addition to these loans, an estimated $1 billion of bilateral and multilateral aid was spent on legal reform projects from the early 1980's to early 1990's alone.[50]

Early on in the transition, the World Bank identified that the effectiveness of its lending operations was being undermined by weak institutions, as well as *inter alia*, "lack of an adequate legal framework, damaging discretionary interventions, uncertain and variable policy frameworks."[51] Governance relates to the manner of conduct of authority, specifically: "the exercise of authority through formal and informal traditions and institutions for the common good."[52] This entails the need to constrain the state,[53] and to hold it accountable;[54] this relies on strong institutions, including legal ones. Legal reform and the rule of law have therefore been subsumed into the global 'good governance' agenda. The Bank's lending for law-reform projects has proliferated under this mandate.[55]

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46 AMCHAM Internet Site, *The Russian-American Business Dialogue.*
47 Hewko 2002, 5.
48 Tamanaha 2005, 2.
49 Klug 2000 cited in McAuslan 2004, 63.
50 Upham 2002, 8.
51 World Bank 1992, 4
52 Kaufmann 2003, 5
53 World Bank 1996a, 88
54 McAuslan 1997, 27
55 Tshuma 1999, 79

As good governance requires transparency and accountability, corruption in client countries has "increasingly been at the heart" of this agenda. The World Bank places great emphasis on legal and judicial reform as a part of its anti-corruption strategy.[56] Renewed efforts in good governance and anti-corruption have been made under the leadership of the new President of the World Bank, Paul Wolfowitz who believes that corruption is "one of the biggest threats to development in many countries."[57] In 2006 the Bank increased its lending for governance, anti-corruption, rule of law and public sector reform projects, with $4.5bn of assistance in the 2006 financial year. In summary, foreign investment promotion has been central to the movement for legal reform, one which is now part of the broader project of good governance.

Despite these loans and projects, Russia is notable for its failure to bring about the rule of law,[58] as well as its poor track record in attracting foreign investment. Many commentators, in accordance with the Dominant Theory, attribute the shortfall in FDI to the woes of Russia's legal climate, in particular, bureaucracy, corruption and the poor enforcement of laws.[59] The country is therefore an apt setting in which to test the Dominant Theory. A summary of the country's FDI record is presented below, while a full analysis of the country's legal climate is undertaken in Chapter Six.

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56 World Bank 2006 Governance Website http://www.worldbank.org/html/extdr/gc/governance/governance.htm

57 See World Bank Development Committee 2006. In April of 2006, the Development Committee of the World Bank and IMF, the body of Ministers from member states which sets the agenda for the institutions, asked the Bank to set out its strategy for enhancing governance and anti-corruption efforts. In September of 2006, the Bank published this strategy.

58 Carothers 1998, 4-6. See also Chapter Six.

59 For example, A.T.Kearney 2003, 21; Schaffer *et al.* 2004, 8; OECD 2002, 6; Bevan *et al.* 2004, 61.

4.3 Russia's Unsuccessful FDI Record

Despite its vast natural resources, large consumer market and educated workforce,[60] Russia has remarkably low levels of FDI, in fact, UNCTAD categorises it as a country, "below potential" in FDI terms.[61] Using a variety of measures, over the period 2001-2003, the organisation ranks Russia 33rd in the world according to how much FDI, relative to the size of its economy, it ought to attract, but 119th in the world for how much it actually receives.[62] On the basis of one FDI statistic - stock of FDI as a percentage of national wealth, Russia's FDI levels in 2003 were around half of the world average, half of the average in Central and Eastern Europe, and a quarter of the levels enjoyed by the Czech Republic and Hungary.[63] Out of nineteen transition countries, only Uzbekistan has a lower proportion of FDI.[64] In a survey by MIGA, 40% of firms interviewed were interested in investing in China in the next three years, 39% in Brazil, 20% in India and 19% in Russia.[65]

A large share of foreign investment in Russia is in the form of loans and trade credits taken by Russian firms, rather than foreign *direct* investment. The country also has very low levels of portfolio investment. One positive aspect of Russia's investment statistics is that foreign direct investors have a high rate of reinvestment: 66% of foreign investment inflows are profits that are reinvested. This shows that foreign investors are looking to expand in the country. Finally, foreign investment is concentrated in two sectors: manufacturing, which accounts for 45% of inflows, and energy, which accounts for 32%; business services, trade services and financial services account for 7%, 6% and 5%, respectively.[66]

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60 Schaffer *et al.* 2004, 13 and A.T.Kearney 2003, 4 and 20-21.

61 UNCTAD 2004a, 17.

62 UNCTAD 2004a, 283 and 290. The FDI 'performance' relates to how much FDI a country receives relative to the size of its economy. UNCTAD rates a country's FDI 'potential' according to twelve 'structural' variables, for example, economic growth, communication infrastructure, tertiary education levels and country risk. See UNCTAD 2004a, 12 and 36.

63 UNCTAD 2004b.

64 Kaitila 2003, 5.

65 MIGA 2002, 21.

66 OECD 2006, 14-17

Foreign investment is considered to be essential to Russia's future development: it is estimated that the country's FDI levels need to increase by five to ten times to achieve its government's own growth targets.[67] In general, it is widely accepted that foreign investment is a vital component of economic development, and is said to bring numerous benefits. For example, foreign investors bring financial capital and access to export markets. Foreign firms have been found to perform better than local ones, and this advantage 'spills over' to local firms, for example, by the transfer of management skills and technology. Foreign investors have also been said to bestow particular advantages in the transition, for example through their participation in privatisation, increasing competition and reducing supply shortages.[68]

4.4 The Difficulty of Establishing a Theoretically Ideal Legal Climate

As the quotations cited in subsection 1.2 point out, the Dominant Theory hinges on the ability to establish a Theoretically Ideal Legal Climate. However, the literature on the institutional determinants of foreign investment is notably divorced from that of legal reform. Advocates of the Dominant Theory seem to ignore the challenge of genuine legal change, and studies that investigate law as a factor in foreign investment, almost without exception, do not take into consideration the prospects for effective legal reform.[69] In contrast, the present study takes this issue into consideration.

In Chapter Six, the challenge of legal reform in transition, in particular, in Russia is analysed. If a Theoretically Ideal Legal Climate was a cheap commodity that could be purchased and installed rapidly, then the question of the feasibility of legal reform would be redundant. The Chapter argues that the disappointments of transition reforms show that establishing a Theoretically Ideal Legal Climate is not a quick and

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67 The Moscow Times 2004a.

68 For benefits at the national level, see UNCTAD 1999, 17-44; for benefits at the firm level, see Bilsen & Maldegem 1999 and Yudaeva *et al.* 2000; for their contribution to transition, see Kalotay 2001. In Russia today, the Foreign Investment Advisory Council of Russia is active in proposing and lobbying for reforms; see the FIAC internet site.

69 Hewko 2002 is the only exception.

straightforward task, but a complex and long term endeavour. This conclusion clearly affects the efficacy of prescribing a Theoretically Ideal Legal Climate as a foreign investment solution. What happens to foreign investment in Russia if the country cannot establish a Theoretically Ideal Legal Climate?

The main aim of Chapter Eight is to show that establishing a Theoretically Ideal Legal Climate in Russia is notably difficult, and to reconsider the merits of the Dominant Theory's prescription in the light of this point. There is no specific hypothesis associated with this issue, nor any dedicated fieldwork. None the less, the issue contributes to a more thorough analysis of the Dominant Theory.

5 Thesis Outline

Chapter Two is titled, "The Importance of the Legal Climate to Foreign Investors: Theoretical Foundations."

Chapter Three is titled, "The Importance of the Legal Climate to Foreign Investors: A Critical Review of the Evidence."

Chapter Four is titled, "Why the Quality of Legal Climates may not be so important to Foreign Investors."

Chapter Five is titled, "Russia's Legal Climate: Past and Present"

Chapter Six is titled, "The Challenge of Establishing a Theoretically Ideal Legal Climate."

Chapter Seven is titled: "Researching Foreign Investors in Russia."

Chapter Eight is titled, "The Impact of the Russian Legal Climate on Foreign Investors."

Chapter Nine is titled, "Conclusions."

Chapter Two

The Importance of the Legal Climate to Foreign Investors: Theoretical Foundations

1 The Principles of Law, Economics and Development

This Chapter explains the theoretical roots of the Dominant Theory, which lie in the concept of the Theoretically Ideal Legal Climate. It shall be argued that the Theoretically Ideal Legal Climate derives from prevailing views in the field of law and development, which itself has been influenced by traditional law and economics. The concept is also influenced by the western rule of law heritage. This analysis follows the efforts of Perry-Kessaris, to put the ideas and literature of law and economics, law and development and the determination of FDI into a coherent framework.[70]

Section 1.1 first explains that the orthodox view within law and development is that the purpose of legal systems is to service the needs of the private sector. Section 1.2 then shows that it is widely accepted that the private sector demands efficiency and certainty from the environment which it operates in, and the legal system forms a vital part of this institutional setting. The tools for analysing 'efficiency' and 'certainty' are then introduced. Section 3 follows by examining the characteristics of legal systems deemed to be most friendly to the private sector, and therefore most supportive of foreign investment.

1.1 The Needs of the Private Sector: Efficiency and Certainty

Our analysis derives from the orthodox position about the role of law in development and legal reform, which is based around the perceived needs of the private sector.[71] Economic growth and poverty alleviation require investment and the creation of wealth. As firms are the main creators of wealth, the investment climate must respond to their needs. The right investment climate is considered to be the key to "unleashing growth and reducing poverty." It encourages firms to invest productively, to create jobs and expand.[72] As we shall see, legal systems are an

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70 Perry 2001.

71 Perry 2000a, 1629.

72 World Bank 2004, 36.

integral component of the what the World Bank considers to be the right investment climate.

The role of the private sector has a historical significance too. In the transition context, the focus on the private sector was inevitable as a private sector did not formally exist under Communism. The economic hallmarks of such systems – a large public sector, nationalised ownership and high levels of regulation had to be replaced by private ownership and a deregulated, market-friendly state.[73] The demise of central planning happened at a time when the private sector orientated, market economics of the Washington Consensus was in the ascendancy.[74] This transition is very much still taking place.

Since the private sector is the end-user of commercial legal systems, the quality of the legal climate is best judged from their perspective. This approach is considered preferable to assessing the legal climate according to the quality of the laws on the books, as, especially in transition countries, there is a difference between how the legal system is meant to function, and how it actually does. Further, an assessment of the quality of legislation does not account for significant factors in the operation of transition legal climates: such as the quality, honesty and efficiency of the courts, the ability to enforce judgements, and the impact of corruption in government.[75]

The extensive body of research on obstacles to business is a testament to the significance that the development establishment attaches to private sector needs. This form of research uses firm surveys and expert opinions to gauge private sector perceptions of a variety of aspects of the business climate, including the legal and regulatory environment. Studies assess the problems faced by economic actors and make appropriate policy recommendations. The World Bank is the leader in this field. For example, its most recent governance research uses 25 sources of data on

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73 Faundez 2000, 3.

74 Naim 2000, 513.

75 See Chapter 8, Section 3

private sector attitudes.[76] It also recently conducted a global private sector survey of over 10,000 firms, and a joint regional survey of over 4,000 firms in transition countries with the EBRD, both of which include foreign investors.[77] Partner organisations such as Foreign Investment Advisory Service (FIAS) and other multilateral organisations such as the OECD also engage in studies on private sector attitudes to the investment climate, which result in policy recommendations with a view to improving conditions for business in the countries under examination.[78]

So what does the private sector demand from the business environment? Perry–Kessaris explains that foreign investors' requirements can be summarised in terms of "efficiency and certainty."[79] This decomposition of the legal climate into two measures – *efficiency* and *certainty* – is a simple and sharp tool for examining the impact of law. Efficiency is important as the general ambition of firms is to maximise profits; as investments are forward looking and require the outlay of capital, firms making them require a measure of certainty about the future. The following section explains these principles in more detail and Section 3 then demonstrates how they have been interpreted and applied to form the paradigm for a Theoretically Ideal Legal Climate.

1.2 The Role of Legal Institutions in Providing Efficiency and Certainty

The principles of efficiency and certainty capture the perspective of the New Institutional Economics (NIE). One of the figureheads of NIE, Douglass North, teaches that the role of institutions in society is to provide a stable structure for human interaction.[80] By determining the 'rules of the game' institutions shape incentives in human exchange, including economic exchange.[81] Thus, according to NIE, economic development can actually be equated with institutional

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76 Kaufmann *et al.* 2004.
77 World Bank, Governance Data internet site.
78 For example, OECD 2001, FIAS 2001.
79 Perry 2000a, 1629.
80 North 1990, 6.
81 North 1990, 3.

development.[82] Economic development, and so private sector needs, depend upon institutions to provide low cost transacting, to allow risks to be priced, and to engender credible commitments.[83] Hence, efficiency and certainty.

The NIE position closely resembles the development orthodoxy. The World Bank states that both ambiguity in the content of laws and regulations, and expectations about how they will be implemented, are potential sources of uncertainty.[84] Buscaglia argues that growth needs a system of rules to enhance risk management in increasingly complex economies; and, further, legal systems are "potential institutional improvements" to these ends.[85] On the question of efficiency, he argues that the very purpose of economic analyses of law in developing countries is to understand what changes would promote economic efficiency.[86]

That economic performance is determined by institutions is now a widely accepted point, supported by a large body of empirical work.[87] The measurement of institutions, like that of legal systems, is a controversial matter, making it very difficult to identify precisely which institutions contribute to development.[88] Nevertheless, it is argued that one of the main reasons for the disparity in progress among transition economies is due to disparities in the strength of their institutions, in particular their legal climates.[89]

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82 Klein 1999, 461.

83 North 1997, 2; Klein 1999, 461.

84 World Bank 2004, 46.

85 Buscaglia 1999, 563.

86 Buscaglia 1999, 565.

87 North 1997, 2; see Burki *et al.* 1998 for a survey of the empirical evidence on institutions and development, and also Shirley 2003, Aron 2000.

88 Shirley 2003, 17; see also Aron 2000 for an analysis of existing evidence on institutions and development.

89 On the subject of institutions and the challenges of transition generally, see Black & Tarassova 2002, 1; Kolodko 2000, 272; World Bank 2002a, xxii; for a survey of the studies conducted, see World Bank 2002a, 16-20; for analysis of institutions and economic performance in the region see Havylyshyn & van Rooden 2003, 19 & 21, Brunetti *et al.* 1997, 26-28 and Moers 1999, 17.

Among institutions, the legal system has received the most attention in the development discourse.[90] The World Bank's position is that fair, efficient, effective legal and judicial systems are the "backbone" of development.[91] The normative view that institutions should provide efficiency and certainty for the private sector applies to legal systems. For example, the Bank holds that a legal climate best promotes national development by meeting the needs of the private sector, specifically, by enabling "resources to be efficiently allocated, business risks rationally assessed and transactional costs kept at low levels."[92]

According to the foregoing analysis, legal systems might influence the decisions of foreign investors because they affect the efficiency and certainty with which firms operate. This principle is the foundation for the proposition that law is a determinant of foreign investment. To test this view we must be able to discern between features, from the perspective of traditional law and economics, of attractive and unattractive legal climates. To do this, the tools for analysising how legal systems affect efficiency and certainty are required. First, efficiency.

1.2.1 Analysing Efficiency: Transaction Costs

The work of Ronald Coase, the father of Transaction Costs Economics, stands out because it establishes the point that the costs of transacting are vital to the analysis of the economic system of firms, markets and the law. In his words, without the concept of transaction costs, it is "impossible to understand the working of the economic system, to analyse many of its problems in a useful way, or to have a basis for determining policy."[93] It has been said that law and economics and NIE are "sub-fields" that have evolved from Coase's ideas and the literature based upon them.[94]

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90 Klein 1999, 459.
91 Quoted in Upham 2002, 10.
92 World Bank 1995, 15.
93 Coase 1988, 6.
94 Allen 1999, 893.

Though Coase's work does not refer to foreign investors specifically, Perry-Kessaris shows how his ideas can be applied in this context.[95] The identification of transaction costs and the preceding arguments about the importance of efficiency show that in the eyes of foreign investors, the attractiveness of a legal climate might be said to depend to a large degree upon the costs it imposes. Where the institutional framework is incomplete, as in transitional states,[96] incoming investors are likely to face higher transaction costs than they would in mature market economies.[97] The concept of transaction costs can be used as a tool for assessing whether features of host legal climates are expected to be attractive or unattractive to foreign investors.

Coase does not provide a definition of transaction costs. In various articles, he employs different phrases to capture the idea. The term 'transaction costs' is how other economists have summarised his ideas.[98] Transaction costs refer to the cost of exchange,[99] of doing business. Coase identifies the existence of three categories of transaction costs: search and information costs; bargaining and decision costs; and policing and enforcement costs.[100] These stages are briefly examined below to highlight the ways in which legal climates might impose costs on foreign investors in Russia.

The first stage of an exchange is the search stage, during which for example, a foreign investor needs to acquire information to identify the right business partner. There is a cost to acquiring reliable information, and in some climates such information may be particularly hard to obtain, forcing firms to go to greater lengths, and therefore undergo higher costs. One of the problems of business in Russia has been, and continues to be, the lack of public information about the ownership and creditworthiness of firms. For example, a recent study found that 50% of foreign investors in Russia felt that they lacked credible and necessary information about

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95 Perry 2001, 33-34.
96 For example, Moers 1999, 4; Roland 2001; Raiser *et al.* 2000, 1.
97 Bevan *et al.* 2004, 46.
98 Coase 1988, 6.
99 Cooter and Ulen 2000, 87.
100 Coase 1988, 6.

Russian companies.[101] Consequently, foreigners have been advised to hire private investigators in order to gather reliable information before engaging in sizeable transactions.[102] Thus, TCE demonstrates the importance of accessible and reliable information.

The second stage of an exchange is the bargaining phase. TCE demonstrates the importance of clear rights during negotiations. Parties are more likely to co-operate, and therefore costs will be lower, when their rights are clear.[103] For example, a foreign investor who wishes to purchase land to build a factory would prefer that the regulations governing such activities stated his rights in clear terms, because if his rights are initially unclear, or the manner of application is uncertain, it will take more time and greater effort and expense (for example, lawyers fees) to ascertain them satisfactorily.

The final stage is known as the enforcement phase. Costs occur here because most business contracts are not fulfilled on the spot, and so performance of the other party must be monitored, and any violation remedied.[104] TCE therefore suggests that legal climates should provide low costs for monitoring contracts and remedying violations. Research has shown that Russian businesses prefer to rely on trust between the firms to enforce agreements and resolve disputes, but if these fail, they gradually take recourse to more formal and laborious, and therefore more costly procedures.[105]

In summary, the identification and significance of TCE has three main implications. The attractiveness of a legal climate can be gauged by the costs of transacting in it. The legal system should therefore serve to reduce transaction costs.[106] The private

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101 FIAC 2005, 47.
102 Brank 2003 and Dean 2002.
103 Cooter & Ulen 2000, 89 and Perry 2001, 34.
104 Perry 2001, 34.
105 Hendley *et al.* 2000.
106 Perry 2001, 36.

sector will prefer to use the legal system if doing so will reduce transaction costs, [107] but we can expect that firms may opt to use other mechanisms, such as informal institutions, if these are cheaper than formal ones.[108] In order to minimise costs, according to Coase's framework, legal systems should offer clear and simple rights, low monitoring costs, and punishments that are cheap to administer.[109]

1.2.2 Uncertainty and Risk

The second quality that the private sector expects from legal climates is certainty. Uncertainty differs from risk, in so far as risk can actually be measured, costed and taken into account.[110] In law and economics, uncertainty not risk is the problem. The key characteristic of uncertainty is that the likelihood of change and therefore its impact are unknown or cannot be estimated adequately.[111]

Uncertainty increases transaction costs,[112] and so uncertainty in the institutional climate generally and legal system in particular is undesirable, while predictability is a virtue. Buscaglia explains that instability in the political climate and the defectiveness of public institutions make private contractual arrangements riskier and in doing so harms private investment. When firms are concerned about the application of laws and realisation of policies, they may respond by not investing at all, requiring higher rates of return in order to invest, or investing more gradually.[113] According to a World Bank study, improvements in policy predictability can make a firm over 30% more likely to invest. Unclear and undefined rules and inconsistent interpretation and application of rules therefore stifle the conditions necessary for

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107 Perry 2001, 35.
108 For example, see Frye & Zhuravskaya 2000.
109 Perry 2001, 36.
110 Knight 1921 cited in Perry 2001, 35
111 Perry 2001, 35.
112 Buscaglia 1999, 563; Perry 2001, 34-35.
113 World Bank 2004, 46-48.

economic growth.[114] And so the World Bank argues that "the worst damage a state can do to its prospects of investment is to cultivate an air of uncertainty."[115]

As with transaction costs, the identification of uncertainty has certain implications for this study. First, the legal system should serve to reduce uncertainty and therefore transaction costs. Second, this can be done by establishing clear rules that are interpreted consistently and adequately enforced. Finally, the private sector will opt to use the legal system if doing so will reduce uncertainty, but we expect that firms may opt to use other mechanisms, such as informal institutions, if these provide greater certainty.

1.3 Summary

The aim of Section 1 was to demonstrate the intellectual building blocks of the Dominant Theory. Section 1 established that the law and development orthodoxy places the needs of the private sector at the heart of its agenda. It was shown that the private sector sought efficiency and certainty from the business environment. It is the role of institutions, particularly legal systems, to provide these. The analysis of transactions costs economics and uncertainty in subsections 1.2.1 and 1.2.2 showed in greater detail how legal institutions can affect efficiency and certainty. The issues of transaction costs and uncertainty highlight the broad features that legal climates should provide if they are to be efficient and certain: clear and simple rules and rights; consistent interpretation of these; and cheap and effective enforcement.

2 A Theoretically Ideal Legal Climate

The principles of efficiency and certainty have been translated into a blueprint for a Theoretically Ideal Legal Climate which the private sector is expected to find most attractive. It is this type of legal climate that advocates of the Dominant Theory claim to be necessary for the attraction and support of foreign investors. Such a legal

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114 Buscaglia 1999, 564.

115 Perry 2001, 55 citing World Bank 1997, 43.

climate is not supposed to be an end in itself, but rather a means of supporting economic development by meeting the perceived needs of the private sector. To reiterate, in this field then, private sector perceptions are the gauge by which the quality of legal climates are assessed. The purpose of this Section is to depict the Theoretically Ideal Legal Climate in detail, and explain why the characteristics of such a legal climate are thought to be attractive to firms.

2.1 The Judiciary

According to the World Bank and likeminded commentators, an appropriate judiciary is the cornerstone of an effective legal system.[116] In fact, it has been stated that the judiciary underpins the credibility of the overall business and political environment.[117] In Russia, "drastic improvements" in the judicial system have been said to be required to provide long-term political and economic stability.[118] The main reasons lie in the role of the judiciary in holding the government accountable and in enforcing agreements.

Government accountability is critical for a Theoretically Ideal Legal Climate.[119] Accountability means that government officials are subject to the law, and that their behaviour should be based on, and limited by a specific legal authority.[120] As the World Bank's mandate does not allow it to be involved in political matters,[121] the courts have been seen as the primary accountability mechanism.[122] A judicial system that does not provide checks and balances against arbitrary state action is considered by the World Bank to be an ineffective one.[123] Government arbitrariness is the antithesis to the predictability and stability that characterise a Theoretically Ideal

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116 World Development Report 2002, 129; Aron J. 2002; Krasnov 2002,93.
117 World Bank 1997, 100 cited in Messick 1999, 120.
118 Remmes 2002, 2.
119 World Bank 2002d, 42.
120 World Bank 1992, 34.
121 World Bank Articles of Agreement, Article III, Section 5(b).
122 World Bank 2002d, 42.
123 World Bank 2002b, 118.

Legal Climate.[124] One reason for this is that corruption is expected to result if the discretion of government officials is unaccountable.[125] Russia provides a prime example of this. The country faces a particularly acute challenge in preventing state interference in economic life and seeing that the state and its officials abide by the law.[126]

According to the World Bank, confidence in the enforceability of agreements is required for the proper functioning of an economy, in particular, for efficient private economic activities.[127] An effective judicial system is thought to be vital in supporting contract enforcement.[128] Hence the role of the judiciary in clarifying and interpreting laws, resolving disputes and enforcing compliance is significant.[129] In order to contribute to investors' certainty concerning their rights and efficiency in protecting them, the courts should ideally resolve disputes in a fair and efficient manner, as "unreasonable delays, uncertainty and high costs in enforcing contracts all tax economic actors inequitably and damage economic efficiency."[130] This requires that the judiciary be independent, efficient and effective.

Their independence is considered critical.[131] Independence means that judges should be shielded from unfair influence from politicians, government officials and parties to a dispute. The judiciary is undermined if the laws and courts are perceived as unfair.[132] The World Bank's concept of judicial efficiency combines the need for fairness with the need for accessibility. Accessibility means that disputes should be resolved quickly and affordably.[133] This assumes that the courts can actually enforce

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124 World Bank 1992, 38.
125 World Bank 2004, 41.
126 This issue is treated in the review of the Russian Legal Climate in Chapter Six.
127 World Bank, 37.
128 World Bank 1992, 37.
129 World Bank 2002d, 33.
130 World Bank 1992, 37.
131 Krasnov 2002, 93.
132 World Development Report 2002; Krasnov 2002, 94.
133 World Development Report 2002, 131; World Bank 1997, 100.

judgements, which should not be taken for granted in Russia.[134] Therefore, the term 'effective' is required to denote that the courts can actually enforce judgements. The judiciary ought to be more effective than informal mechanisms as, ideally, it will have the coercive power of the state available to it to enforce its decisions.[135]

The Bank holds that the greater the confidence had in the judiciary, the lower the risks and costs of transacting.[136] There is evidence of the economic impact of the courts from Russia and the wider region. Frye shows that in Russia, firms that believe that arbitration courts can protect their rights in disputes with the state planned to invest at higher rates than those that did not.[137] Johnson *et al.* show that when courts are perceived as effective, transactions costs are lower. In such cases, firms are also more likely to trust one another and to seek new partners, which improves competitiveness.[138]

2.2 Laws and Regulations

In a Theoretically Ideal Legal Climate, the rules and laws themselves must be "consistent with the needs of a free market."[139] This suggests a suite of commercial laws that create certainty for investors, allow markets to function efficiently and thereby encourage investment. Above all, hosts must have enacted laws permitting the incorporation of joint-stock and limited liability companies. Other bodies of commercial legislation that are can reduce the risks investors face include: shareholder protection laws, insolvency laws, securities laws and intellectual property laws. Legal reforms in post-Communist states involved, and continues to involve, the development and enactment of these and other commercial laws.

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134 Frye 2002, 126; OECD 2001, 5-6; Hendley *et al.* 2000, 645-646.
135 World Bank 1997, 100.
136 World Bank 2004, 86.
137 Frye 2002, 128.
138 Johnson *et al.* 1999.
139 World Bank 'Private Sector Development' internet site, page on 'Making Laws and Regulations More Predictable', visited on 14/8/05.

The attributes of laws and regulations can have a significant impact on the certainty and efficiency that investors face. Rules that are stable, accessible and clear are preferable to those that are unstable, obscure, and subject to broad interpretation, as these characteristics can evidently be a source of uncertainty for firms. In particular, they invite arbitrary government behaviour and corruption.[140] Firms also incur higher transaction costs when laws are inaccessible or ambiguous.[141] A confusing and burdensome legal framework, in accordance with transaction costs analysis, increase costs and is therefore said to dissuade investors.[142] In fact, the instability of laws has been singled out as the "most pervasive legal risk" for a foreign investor.[143]

The content of regulations can also affect transaction costs. At the outset of an investment, regulations can determine the cost of starting a business, such as business registration, licensing or acquiring real estate. During the operating stages, further costs can be incurred by the need for compliance with regulations, such as installing particular equipment or closing a business down for a period; the time cost of compliance; or the cost of licensing fees. [144] All else equal, a firm is expected to prefer to invest in a state with fewer regulatory constraints, which is why disclosure requirements, antitrust controls and corporate liability have all been observed to influence the choice of host.[145] This thesis, is focussing on the overall perceived impact of the Russian legal climate, rather than the role of a specific body of law.

2.3 The Behaviour of Government Officials

As the responsibility of applying laws and regulations lies with government officials, their behaviour is a critical aspect of the attractiveness of a legal climate. The discretionary authority of government officials is considered, in principle, to be

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140 Gray & Kaufmann 1998, 9.

141 Perry 2001, 56-57.

142 World Bank 2000, 18.

143 Pritchard 1999, 2.

144 For examples of the procedures related to starting a new business across the world, see: World Bank, "Doing Business" website and related publications by Djankov *et al.* 2001 and 2003; for a colourful description of business registration in Russia, see Black and Tarassova 2002, 34-35.

145 Muchlinski 2002, 44

desirable to a Theoretically Ideal Legal Climate to the extent that it enables flexibility in the application of regulations.[146] However, probably because of the existing weaknesses in transition legal climates, the orthodox view, as seen in the Dominant Theory, stresses the importance of predictability and transparency. It is claimed that these features are best ensured if government officials have less discretion.[147] Moreover, public choice theory dictates that public officials are self-serving.[148] So, to foster greater certainty in the application of laws and regulations, the exercise of discretion by government officials should be limited by procedural rules on how their authority can be applied.[149]

As bureaucratic discretion can foster uncertainty[150] and increase transaction costs,[151] a non-discretionary 'transparent' legal framework is considered to be central to the vision of a Theoretically Ideal Legal Climate,[152] and also indispensable for foreign investment.[153] This can be seen particularly clearly when considered against the pervasiveness of arbitrary action in some transition legal climates. For example, the discretion of public officials has been labelled as a "systemic weakness" in transition economies, one that is "exacerbated by poorly defined, ever-changing, and poorly disseminated rules and regulations."[154] Bureaucratic discretion has even been said by various commentators to have reduced investment in the region.[155]

Arguably the most important reason why discretion is unwelcome is that it can lead to the abuse of an official's position in the form of bribe taking. Corruption is likely to arise when discretion is coupled with 'monopoly' power and a lack of

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146 World Bank 1992, 34.
147 Perry 2001, 63.
148 Tshuma 1999, 78.
149 World Bank 1992, 35.
150 Berglof *et al.* 2004, 99.
151 Buscaglia 1999, 563.
152 Tshuma 1999, 79 & 82.
153 Michalet 1997, 3.
154 Gray & Kaufmann 1998, 9.
155 Berglof *et al.* 2004, 99; Shiells 2003, 23; Gupta *et al.* 2002.

accountability for the application of authority.[156] In developing countries, and in particular in transition ones, the incentives for interference are high as the state retains significant regulatory power, but lacks a credible threat of sanction by which to restrain its officials.[157] Empirically, a linear relationship has been traced between increasing levels of both government discretion and corruption.[158] Further, too much discretion in a corrupt environment leads to bad lawmaking.[159]

Corruption is considered to be the arch-enemy of a Theoretically Ideal Legal Climate.[160] But why, from a private sector perspective, is corruption undesirable? The argument that bribery merely gives firms a means of sidestepping burdensome and ineffective regulations is undermined by the following points. Politicians and bureaucrats, especially in corrupt societies, have enormous discretion in the creation, interpretation and enforcement of rules. So a corrupt environment can actually fuel the growth of excessive and discretionary regulations, and hence transaction costs and unpredictability.[161] Thus it creates a 'constituency' for unnecessary regulations.[162]

Corruption is also said to create an un-level playing field, which deters new investors and outsiders.[163] In Russia, corruption is alleged to prejudice foreign firms more than domestic ones, for two reasons: first, corrupt government officials and judges have frequently been in league with or manipulated by local business partners or competitors against the interests of foreign investors; and second, foreigners are deemed to be less adept at bribing local officials.[164] Corruption is therefore viewed by some as an extra 'tax' on foreign investors.[165]

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156 World Bank 2004, 41.
157 World Bank 1996a, 95; also OECD 2001, 18-19.
158 Berglof *et al.* 2003, 52.
159 Black and Tarassova 2002, 13-14.
160 Black & Tarassova 2002, 11-18.
161 Gray & Kaufmann 1998, 8.
162 World Bank 2004, 40; Black & Tarassova 2002, 12-13.
163 FIAS 2001 Executive Summary, iii, x.
164 Black & Tarassova 2002, 15.
165 Wei 2000.

Typical instances of bureaucratic corruption can be seen in the issuing of licences and permits, and the speed with which they are granted; in inspections of business premises for compliance with health, environmental or fire codes; and in the clearance of goods in customs.[166] Business surveys enquire about bureaucratic intervention and the pervasiveness and cost of corruption.[167] They show that the need to negotiate with regulators consumes managers' time, thereby increasing transaction costs, and possibly reducing firm growth.[168]

2.4 Summary

Ideally, legal systems should provide foreign and domestic firms with security of rights, predictability of expectations, and efficiency in securing rights. The preceding subsections have shown how the characteristics of legal systems can provide an environment that would, all else equal, encourage foreign and domestic investment. A judiciary that holds government accountable, arbitrates disputes and enforces agreements is essential to providing a secure, transparent and predictable environment for foreign investment. Laws and regulations that are market-orientated, stable and clear are the next ingredient of the Theoretically Ideal Legal Climate for foreign investment. In order to provide stability of expectations and therefore to enable foreign investors to manage the risks of investing, the legal climate should be transparent, in particular, in the formulation, amendment, interpretation and enforcement of laws. The role of government officials in the judicial system, customs, taxation and business regulation, is critical in securing a predictable, transparent and non-discretionary legal climate. Therefore legal systems in which government officials are accountable and not corrupt are generally considered to be preferable and more attractive to foreign investors.

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166 Zhuravskaya & Zamulin 2003; World Bank 2002a, 59-62.

167 For example, see World Bank 2002c.

168 Beck *et al.* 2002, 21.

3 The Rule of Law and a Theoretically Ideal Legal Climate

The concept under examination in this thesis, the Theoretically Ideal Legal Climate for foreign investment, is derived from the much broader, well established, yet disputed concept of the rule of law. The aim of this final section is to highlight this connection and heritage, and to clarify that our concern is not with the general notion of the rule of law, but exclusively with the narrower concept of the Theoretically Ideal Legal Climate, and more specifically, with its application as a theory of the relationship between foreign investors and the Russian legal climate.

In a recent book, Tamanaha comprehensively examines the history, politics and theory of the term, the 'rule of law'. Countless theorists, from Aristotle to Hayek, Hobbes to Weber, Locke to Dworkin, have dwelled on the importance and meaning of the rule of law, or concepts which fall under its umbrella, and gone on to develop formal and substantive theories relating to it. Analysing their works, Tamanaha identifies three "clusters of meaning" within the term, which he terms as follows: government limited by law; formal legality; the rule of law, not men.[169] The Theoretically Ideal Legal Climate is derived from these traditions, most notably, from the first two clusters.

According to Tamanaha, 'formal legality' is the dominant understanding of the rule of law for liberalism and capitalism. Formal legality was advocated by Hayek and Weber. Both argued that a formal rule-orientated system was required to provide security and predictability, although their emphases differed.[170] Formal legality is based on the attributes of laws, in particular, their generality, certainty, clarity and prospectivity, but not their actual substance. Similarly, the World Bank's classical

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169 Tamanaha 2005, Chapter 9.

170 Tamanaha 2005, 97.

'recipe' for an ideal legal climate is concerned with process of formulating and applying rules, rather than their actual substance:

> "(a) there is a set of rules known in advance, (b) the rules are actually in force, (c) there are mechanisms ensuring application of the rules, (d) conflicts are resolved through binding decisions of an independent judicial body, and (e) there are procedures for amending the rules when they no longer serve their purpose."[171]

Since laws are not self-enforcing, but are enforced by agents of the state, such as judges and bureaucrats, the regulation of government authority is a critical aspect of a Theoretically Ideal Legal Climate, as both the extract above and subsection 2.1 made clear. To ensure that officials abide by the law, the judiciary must be independent, and thereby able to hold government officials to account. Thus, the Theoretically Ideal Legal Climate also draws on the understanding of the rule of law as 'government limited by law'. This understanding of the rule of law is the oldest and broadest, predating liberalism and capitalism;[172] in the classical tradition, it was advocated by Aristotle and Plato, and came to life in the Magna Carta. Liberal political thinkers such as Montesquieu, who stressed the independence of the judiciary, and lauded the freedom of the English to engage in private commerce, have shaped western political thought, and thereby, the notion of a Theoretically Ideal Legal Climate. Government limited by law has two meanings, both of which are elements of the Theoretically Ideal Legal Climate: first, that government officials abide by current laws, and second, that their power to change the law is constrained.[173]

The liberal heritage of the rule of law and its link with capitalism is also seen in the model of the Theoretically Ideal Legal Climate. According to Tamanaha, the "rule of law today is thoroughly understood in terms of liberalism."[174] The concept of the rule

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171 World Bank 1992, p.30
172 Tamanaha 2005, 115
173 Tamanaha 2005, 115-117
174 Tamanaha 2005, 32

of law that has been inherited in the West has been shaped by the ideas of liberal thinkers, such Montesquieu and Locke, who were active during the rise of capitalism in England. Liberalism is concerned with freedom, while capitalism depends upon economic freedom: economic liberty permits the freedom of contract, the protection of property rights, and the accumulation of capital. In practise, by protecting property rights and allowing commerce, liberalism tends to favour property holders.[175] For this reason, Marx dismissed the alleged neutrality of law, criticising liberalism for its bias towards the bourgeoisie, arguing that "your jurisprudence is but the will of your class made into a law for all."[176]

The Dominant Theory is also a product of more recent activity in the field of law and development. During the 1960's and 1970's the 'first' law and development movement attempted to use legal reform as a means of spurring economic development, mostly in Latin America and Africa. The movement was inspired by modernisation theory, which taught that development was a "process of convergence on the institutions of developed Western societies", and that therefore development could be hastened by borrowing western models.[177] Legal transplantation is a prime example of modernization theory at work.

Among the theoretical beliefs behind this movement was the 'liberal legalism' paradigm of American legal scholars, David Trubek and Marc Galanter. Liberal legalism was both a model of the relationship between law and society, and an explanation of the relationship between law and development. The paradigm was politically, socially and economically ambitious. The role of the state in the creation and enforcement of laws was central to the liberal legalism paradigm. Rules were expected to be made in a pluralistic process which enabled all to secure their interests. Laws were also intended to achieve social purposes. Finally, and most

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175 See Tamanaha 2005, Chapter Three.
176 Quoted in Tamanaha 2005, 51.
177 Davis & Trebilcock 2001, 22

importantly, "'law' was seen as a necessary element in 'development' and a useful instrument to achieve it."[178]

The revival of law and development started in the 1980's and accelerated in the 1990's after the collapse of Communism.[179] Today, the Theoretically Ideal Legal Climate is part of the World Bank's governance agenda.[180] The liberal legalism model is broader and more ambitious than the Theoretically Ideal Legal Climate, nevertheless, at the heart of both models is the same belief in the role of law in economic development, coupled with the attributes of legal systems that are expected to support development.

While the rule of law as a political concept has a deep and rich history, the purported role of legal *reform* as a catalyst for economic development, is not so firmly established. The alleged successes and failures of the law and development movement are not of direct relevance to this study, though discussion of the efficacy of legal reform in the context of Russian legal reform is the main topic of Chapter Eight. At this point it is sufficient to note that even advocates of the relationship between Theoretically Ideal Legal Climates and economic development have questioned both the necessity of legal reform for development, as well as the effectiveness of legal reform. For example, Posner says that economic development may in some circumstances be preferable without legal reform, and that "wide deviations" from the Theoretically Ideal model may not harm economic efficiency.[181] A senior figure at the World Bank has also expressed scepticism about whether legal and judicial reforms are an effective means of improving governance in transition countries.[182]

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178 Galanter & Trubek 1972, 1073
179 Perry 2001, 50
180 Tshuma 1999, 79
181 Posner 1998, 2
182 Kaufmann 2003, 21-25.

The Theoretically Ideal Legal Climate therefore has a deep heritage in what is often referred to as the rule of law. This study is by no means seeking to question the validity of the rule of law as a political ideal, nor criticise the value of rule of law goals, such as limitations on government power, predictable and efficient justice, or equality before the law.[183] Instead, this thesis is questioning the alleged importance placed by foreign investors in Russia circa 2004, on a particular narrow derivative of the rule of law ideal, the Theoretically Ideal Legal Climate.

4 Summary

The following extract, cited in Chapter One, exemplifies the Dominant Theory:

> "The most effective action by host country authorities to meet investors' expectations is: safeguarding public sector transparency, including an impartial system of courts and law enforcement ..."[184]

This Chapter aimed to explain the theoretical basis of the Dominant Theory. At the outset it was established that the development orthodoxy places the needs of the private sector at the heart of the development agenda. It was then shown that the legal climate most supportive of the private sector was one that provided predictability and efficiency for the investor. These two overarching goals have been translated into the blueprint for a Theoretically Ideal Legal Climate, one which is considered to be most attractive to domestic and foreign investors alike.

The theory behind the Dominant Theory holds that the costs of transacting in a host state affect its attractiveness. According to this body of theory, the efficiency, predictability and low transaction costs that investors are supposed seek from the legal system is best ensured by an effective, efficient and fair judiciary and

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183 Belton 2005, 8-14.

184 OECD 2003, 7, quoted in Perry-Kessaris 2005, 170.

bureaucracy.[185] These institutions should be free from corruption and have limited discretion. They should apply laws and regulations effectively and consistently. The rules themselves should be market-friendly, clear, stable and not subject to broad interpretation.

This Chapter has demonstrated why foreign investors should ideally desire a Theoretically Ideal Legal Climate, and what the features of such a climate are. But this study is not questioning whether foreign investors should in theory prefer such legal climates, but whether, in practise, the quality of host legal climates actually affect foreign investment decisions in the way supposed. While it is clearly understandable that foreign investors *should* be attracted to country's with efficient and predictable legal climates, the biggest problem with the Dominant Theory is that the evidence that they *actually are* so attracted is problematic and hard to find.[186] The next Chapter examines the evidence.

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185 Upham 2002, 10; OECD 2002a, 9; Berglof *et al.* 2004, 99.

186 Perry-Kessaris 2003, 650.

Chapter Three:

The Importance of a Theoretically Ideal Legal Climate for Foreign Investors: A Review of the Evidence

Introduction

The Dominant Theory represents a belief in the critical role of host legal systems in the attraction of foreign investment; as such, it is a theory of foreign investment determination, specifically, law as a determinant of foreign investment. This Chapter examines the evidence on law as a determinant of foreign investment, focusing as far as possible on the transition region and Russia in particular. Research on the role of law in foreign investment can be divided into two main categories according to the method applied: studies based on the statistical technique known as 'regression', and surveys of foreign investors' decisions. We shall consider the methods, limitations and findings of each approach in turn, starting with regression. The aim is twofold: to assess to what extent the two types of evidence available support the Dominant Theory; and to point out what the limitations suggest about directions for further research.

1 Regression Studies

Much of the research into the determinants of foreign investment has been conducted using the statistical technique known as regression. Before looking at the evidence itself, the regression method and its limitations need to be made clear. It will be argued that the application of the technique for the purpose of identifying whether law is a determinant of foreign investment has significant drawbacks. These are grave enough that, relying on this evidence alone, one cannot reasonably assert that a Theoretically Ideal Legal Climate is necessary for the attraction of foreign investors.[187]

1.1 The Regression Technique and its Limitations

There are ten specific problems with the use of the regression technique for establishing law as a determinant of foreign investment; the limitations fall into three

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[187] For a more extensive critique of the statistical approach, see Perry-Kessaris 2003.

categories: estimating the quality of legal climates, underlying presumptions about foreign investor behaviour, and explanatory power. So that the reader can refer back to these, the problems will be labelled and numbered.

In regression analysis, data is collected about levels of FDI across a group of countries and span of years. Data is also collected relating to the 'explanatory variables' being used, that is, the factors that are being hypothesised as potential determinants of FDI. Comparing levels of FDI and the explanatory variables, a model is crafted that indicates with what certainty the various factors across sample countries 'explain' foreign investment flows.

1.1.1 Problems in Estimating the Quality of Legal Climates

Where these explanatory variables are quantitative phenomenon, such as the level of GDP per head, this is relatively uncontroversial. However, measuring law as a determinant of FDI requires numerical estimates of the quality of legal climates. These approximations are known as 'proxies' or 'indicators', and much hinges on how these are chosen.[188] Measuring complex qualitative phenomena such as the quality of legal systems is problematic and controversial. Proxies can capture only some aspects of the phenomena being estimated, and therefore lead to conclusions that vary enormously and often conflict.[189] The precise challenges of quantifying the quality of legal climates will now be elucidated.

One, 'discerning'. In her critique of World Bank indicators, Perry-Kessaris draws attention to the fact that the World Bank itself cautions that even in its most comprehensive governance indicators, the 'GRICS', it is difficult to "identify statistically significant differences in governance among the majority of countries."[190] This means that it is difficult to discern between the governance quality of similar

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188 World Bank 1996, 1-2.

189 World Bank 1996, 2.

190 Kauffman et. al 1999a, 2, quoted by Perry-Kessaris 2003, 9.

countries, which is precisely what the statistical studies on law as a determinant of foreign direct investment aim to do.

Two, 'narrowness'. Legal indicators may be of limited application because they only capture a narrow set of variables. For example, another World Bank measure, the Doing Business database,[191] which is the most objective indicator available, is of limited use as it only measures "official requirements, official cost and official time"[192] and does not account for the impact of bribery and middlemen in bureaucratic and judicial processes. In the case of transition economies, this must be viewed as a serious limitation.

Three, Four & Five. Kevin Davis points out three further problems with the use of legal indicators: *Three, 'overlap'.* Though purporting to, the indicators may not in fact measure purely legal factors, but may overlap with non-legal institutions, for example, political ones. *Four, 'vague'.* Indicators may be unclear or too highly aggregated, for example they may simply refer to 'the quality of the legal system' or 'the rule of law'. Indicators which are too broad do not facilitate the identification of specific parts of the legal climate that are important in the attraction of FDI. *Five, 'fixed'.* Finally, the indicators used may capture measures that are not amenable to reform, such as a country's legal heritage, making such studies redundant for our purposes.[193]

1.1.2 Underlying Presumptions about Foreign Investor Behaviour

Regression is also an inappropriate method for assessing the role of law in the decision to invest as its application is not based on a theoretical model dedicated to the task. Instead of testing an established model of foreign investment behaviour, the

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191 World Bank, Doing Business internet site.

192 Djankov *et al.* 2001, 1, quoted by Perry-Kessaris 2003, 12.

193 Davis 2004. Davis' focus is on the application of legal indicators in studies associating law and economic development. His criticisms still hold for FDI studies as both types of studies rely on the quantification of legal systems. Also, FDI itself is one measure of economic development.

application of the regression technique makes unverified and unspoken presumptions about how foreign investors are expected to perceive and respond to host legal climates, as shown below.

Six, *'information'*. Legal indicators in regression studies must reflect the perspective of potential foreign investors. More specifically, the use of a particular proxy for the host legal climate should resemble the information that foreign investors incorporate into their decision making process. So by using, for instance, survey data from the World Bank, researchers presuppose that such data reasonably reflects the type of information around which foreign investors' perceptions of legal climates are formed. This is a significant presumption, but one which has not been verified. To illustrate, one study actually found that foreign companies find the opinions of other foreign investors in Russia to be the most reliable source of information on investment.[194]

Seven, 'responsive'. This is the critical presumption at the heart of both the Dominant Theory and the use of regression to test it. The use of the regression model to identify law as a determinant of FDI presumes that potential foreign investors will avoid hosts if they perceive that the host legal climate is weak. Chapter Four will explore to what extent both of these presumptions are contentious. For the time being it is useful to keep in mind that that the only study to actually test them, by Perry-Kessaris, in fact refuted them.[195]

1.1.3 The Explanatory Power of Regression Analysis

The final category of limitation of the regression approach is its explanatory power.

Eight, 'causation'. Regression studies show correlation, for example that the level of FDI rises as the quality of the legal climate improves. But correlation does not actually prove causation, and may well not, in our context, even *indicate* causation.

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194 FIAC 2005, 48.

195 Perry 2001, 97-137.

The reason that it may not even indicate causation is that the variables included in the model are unlikely to be independent from one another, but instead influence one another.[196] For example, it is widely held that legal systems affect economic growth, but some also argue that economic performance influences the quality of the legal climate;[197] legal institutions are also said to influence FDI flows, while FDI levels are related to economic growth both as a cause and effect.[198] Thus it is hard to discern whether the legal system is directly affecting foreign investment, or whether the relationship is part of the dynamic and interrelated system of politico-economic change that transition countries undergo.

Nine, 'outside factors'. One can never be sure that there is not an influential factor that has not been included in the model which, if added, would change the findings. For example, in a recent regression study, a group of economists concluded that human capital, which is rarely included in such studies, was much better than institutions at explaining economic growth.[199] This contrasts with the broad consensus that institutions are the key to economic growth.[200] This finding further suggests that human capital may therefore a determinant of FDI, a point which one study in fact asserts.[201]

Ten, 'structure'. Finally, Davis draws attention to the fact that econometric studies do not trace the 'structure' of the relationship between foreign investment and host legal climates. Thus they cannot tell us whether the legal climate is important to foreign investors only up to a point. It may be the case that a legal system, while far from

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196 This limitation, known as 'endogeneity', frequently arises in regression studies measuring the role of institutions in economic growth generally. See, for example, Aron 2000, 114; Rodrik 2004, 12. Bénassy-Quéré *et al.* argue that most FDI regression studies do not tackle the endogeneity bias. Bénassy-Quéré *et al.* 2005, 11.

197 Abed & Davoodi 2000, 37-38; Raiser *et al.* 2000, 21.

198 Meyer & Pind 1998, 18; Bevan & Estrin 2000, 4-5.

199 Glaeser *et al.* 2004.

200 For a survey of the empirical research, see World Bank 2002a 16-20 and Burki & Perry 1998, 18-19.

201 Miyamoto 2003.

ideal, may be *satisfactory* in the eyes of certain foreign investors.[202] This point hints at the elusive question of how good a legal climate needs to be attract foreign investors.

1.2 Regression Findings

Even if we temporarily put these concerns to one side, the evidence found in regression studies still does not provide a convincing argument that law is an important determinant of FDI. While there is some suggestion that law acts as a determinant of FDI, economic factors provide a much more robust explanation of FDI flows. The evidence that indicates that law is a determinant of FDI is inconsistent. Unless otherwise stated, all references are to research on FDI within the transition region.

1.2.1 The Host Economy as a Determinant of FDI

Research consistently finds that the most significant determinant of foreign investment is the host's economy. This is often measured as the level and growth of GDP per capita. These reflect the size and growth of average income and therefore the market opportunity, and are especially important for 'market-seeking' investors who aim to capture the potential of emerging markets.[203] Major international institutions, such as the World Bank, UNCTAD and the OECD confirm the importance of growth as a driver of foreign investment in developing and developed countries. They also note the importance of economic stability.[204]

This principle holds true in the transition region. Studies on the determinants of FDI into Central and Eastern Europe conclude that the main factor driving FDI in the

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202 Davis 2004, 11. Perry-Kessaris also suggests this, having found that foreign investors perceived that the Sri Lankan legal climate did not conform to the theoretical ideal, but would still invest in the country in hindsight of this. See Perry 2001, 125-126.

203 Dunning 1998, 53. Discussed in Section 1 of Chapter Four. 'Market-seeking' is a label assigned to foreign investors whose motivation for investment is to sell their goods and services in the host country.

204 OECD 2001, 4, UNCTAD 1999, 48; World Bank 1996, 1.

region during the second half of the 1990's was the aim of securing access to local markets; thus bigger markets attracted greater investment.[205] This has been backed up by studies on the motivation for investment in the region. A recent survey of foreign investors in Russia found that 88% of potential investors felt that the size of the domestic market was the main investment advantage of the country.[206] Another, in Hungary, showed that 61% of investors surveyed there considered "obtaining or increasing the share in local market sales" as the most important motivation for their investment decision.[207]

1.2.2 The Host Legal Climate as a Determinant of FDI

We now turn to the first of the two bodies of research that advocates of the Dominant Theory might use to support their claim. Conducted mainly by economists, regression studies are the most common empirical source for the claim that the quality of host legal climates are a determinant of foreign investment. There are numerous regression studies that analyse the possibility that host legal climates are determinants of FDI. Overall, they do not provide support for the Dominant Theory and fail to provide a clear idea of the role of law in the decision to invest. Some of the studies examine legal climates in broad terms, while others aim to assess the importance of specific legal issues, including those features of legal systems that were highlighted in the last Chapter as important to investors, such as the quality of the judiciary, the procedural regularity of law-making, and the extent of corruption.

Studies on specific legal issues are mixed and inconsistent. Corruption provides a good example of this. Wang finds that levels of foreign investment in developing countries do not depend on the perceived level of corruption of those economies.[208]

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205 Bevan *et al.* 2003, 20; Bevan and Estrin 2000, 4; Lankes & Venables 1996, 332-333.
206 FIAC 2005, 33.
207 Elteto & Sass 1998, 11.
208 Wang 2000.

Busse & Hefeker also find that, in transition economies, levels of FDI do not depend on the levels of host country corruption.[209] However, in support of the Dominant Theory, corruption has been found to be significant in explaining FDI flows in three studies of transition economies.[210] One of them, by Abed and Davoodi, finds that corruption appears to be a significant determinant of FDI *until* one takes into account progress on economic reforms. When progress on economic reforms is added to the regression model, corruption loses its significance as a determinant of FDI patterns.[211] This means that, when one considers both progress on economic reforms and corruption *together* as potential factors, investors' decisions are better explained by the former than the latter.

Another of these studies, by Smarzynska & Wei, is interesting because, in addition to showing that corruption apparently deters FDI, it also shows that corruption increases the likelihood that foreign investors will take local partners.[212] This simple point demonstrates that foreign investors should not be presumed to be passive, but that they can react to perceived challenges in the legal climate. Overwhelmingly, this point is overlooked in the foreign investment determination literature.[213]

Regression studies that examine the content, application and stability of laws as determinants of FDI are also inconsistent. While predictability is deemed to be a crucial element of a Theoretically Ideal Legal Climate, a 1997 study by Brunetti *et al.*, based on firm surveys, found that the predictability of laws and regulations was not significant in explaining FDI flows.[214] Bevan *et al.* found that the quality and scope of legislation better explained FDI flows in the transition region than the effectiveness of their implementation. This implies, in contrast to the Dominant Theory, that foreign investors are more concerned about the content of the law than its

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209 Busse & Hefeker 2005, 12.

210 Smarzynska & Wei 2000; Abed & Davoodi 2000; Brunetti *et al.* 1997.

211 Abed & Davoodi 2000, 33.

212 Smarzynska & Wei 2000.

213 Chapter Four, Section 3.1 examines the evidence about foreign investors and corruption in detail.

214 Brunetti *et al.* 1997, 18.

application. However, in support of the Dominant Theory, the same study found that in Russia, the opposite was true.[215] Again in support of the Dominant Theory, Brunetti found that the quality of the judiciary was important in explaining differences in FDI levels in transition countries.[216] Finally, one study found that investment risk, as measured by contract viability, payment delays and the risk of expropriation, were significant in explaining levels of FDI across a group of 83 developing countries, including transition ones.[217]

Regression studies that take into consideration the protection of property rights in host countries provide more consistent findings, but are still problematic. The same study by Brunetti *et al.* found that the security of property rights was significant in explaining differences in FDI levels in the transition region.[218] Brunetti's findings are seconded by Moers, who also identifies property rights as a determinant of FDI in transition.[219] However, while these results show that the security of property rights is important to foreign investors, they say nothing about the type of legal climate is that is required to guarantee them. Property rights can be secured in legal climates that do not resemble the theoretical ideal, for example by informal institutions,[220] or even by dictators who chose to respect property rights.[221] Finally, the concept of property rights used in Brunetti differs from the concept that features in the Theoretically Ideal Legal Climate. The 'property rights' measure in Brunetti derives from responses to questions that focused on theft, crime and personal safety, rather than contract enforcement and economic rights.[222]

Two studies using the same commercial indicator, the ICRG, provide more consistent support for the Dominant Theory. Busse & Hefeker, and Kinoshita & Campos both

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215 Bevan *et al.* 2004.
216 Brunetti *et al.* 1997, 32.
217 Busse & Hefeker 2005, 4 & 13.
218 Brunetti *et al.* 1997.
219 Moers 1999.
220 World Bank 2002b, 173.
221 Glaeser *et al.* 2004, 8.
222 Brunetti *et al.* 1997, 10.

draw on a selection of legal indicators that are part of a commercial risk index called the 'International Country Risk Guide', developed by the firm, *Political Risk Services*.[223] The indicators are based on expert assessments. Both studies find that law and order, and the quality of bureaucracy are determinants of FDI flows. The law and order indicator is an assessment of the strength and impartiality of the legal system, and the popular observance of the law. Busse & Hefeker find that the quality of the bureaucracy, measured according to its political independence, is a determinant of FDI.[224] Kinoshita & Campos find that the quality of the bureaucracy, measured both according to its political independence but also according to the ease of the regulatory environment, is also a determinant of FDI.[225]

Some studies employ 'composite' legal indicators, for example, they assess the 'rule of law' by bringing together different measures of legal climates into a single indicator. Two studies did just that. Both Moers and Wilhelms found that proxies for the rule of law are significant determinants of FDI, in the transition region and emerging economies, respectively.[226] Wilhelms' measure, however, suffers from one of the shortcomings raised by Davis (Regression Limitation Three): it does not measure legal factors alone, but mixes them with the soundness of its political institutions and the orderly succession of power.[227] This is a limitation that is common to a further three studies that might be said to cover the question of law and FDI, which will now be addressed.

Brunetti *et al.'s* study found that a composite measure of the institutional environment, called the 'credibility of rules', accounted for no less than 70% of the variation in FDI flows in transition countries between 1990 and 1995.[228] Their analysis tests the idea that foreign investors require that host investment climates be endowed

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223 The methodology used by the firm for the International Country Risk Guide is explained on its internet site: www.icrgonline.com

224 Busse & Hefeker 2005, 4 & 9.

225 Kinoshita & Campos 2004, 17 & 22.

226 Moers 1999 and Wilhelms 1998.

227 Wilhelms 1998, 18.

228 Brunetti *et al.* 1997, 22.

with a measure of predictability, which is provided by institutions. Their study would appear therefore to provide support for the Dominant Theory. However, their study cannot be applied here because their composite indicator mixes legal and non-legal institutions. For example, it includes questions about whether government policy is responsive to business interests, and what firms perceive to be the expected impact of constitutional and unconstitutional changes of government.[229] It therefore falls foul of Regression Limitation Three.

1.3 Conclusions

This review of the main body of research that might have formed the basis for the Dominant Theory drew on eight studies. The studies, however, cannot be said to provide convincing support the Dominant Theory for any of following three reasons:

1. Problems in estimating the quality of legal climates
2. Unverified and questionable presumptions about investor behaviour
3. The limited explanatory power of regression analysis

When if we set aside these three important methodological limitations, the findings themselves on specific legal issues, such as corruption, the content and application of laws, and security of property rights are inconsistent. All in all, the regression evidence, which is the most substantial body of research connecting law with FDI, provides only lukewarm support for Dominant Theory. It suggests that law may affect foreign investment decisions, but certainly falls short of establishing that the quality of host legal climates is of critical importance to foreign investment decision making.

The methodological limitations, coupled with the inconsistency of the findings suggest that there is much to be learned about law and foreign investment. The

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229 Brunetti *et al.* 1997, 15.

regression method, and the findings it produces, do not provide enough insight into the role of law in foreign investment decisions, in particular: how potential investors perceive and react to host legal climates; to what extent the approach of investors may differ; and why investments are made even when investors perceive legal climates to be theoretically weak. Regression studies, as well as most surveys on the motivations and barriers to investment, are too indirect to tell us about the actual role of the law in the decision to invest. This research study takes these limitations as a starting point, and moves on to address some of the outstanding issues by taking as direct a research approach as circumstances allow.

2 Surveys on Factors in the Investment Decision

The second category of research that advocates of the Dominant Theory might use to support their claim consists mainly of firm surveys that attempt to address the role of law in foreign investment. Conducted usually by business associations concerned with foreign investment attraction as well as by legal scholars, these studies address the issues at hand more directly than the regression studies, although often not directly enough.

Seven pieces of research are reviewed. With the exception of a unique study of foreign investors in Sri Lanka and one worldwide study, the studies are all concerned with foreign investment in the transition region. The studies follow different formats. Five of them focus on the motivations and barriers to investment; another examines foreign investors' actual and hypothetical behaviour, while the final study presents anecdotal evidence from a lawyer. On balance, the studies show that the Dominant Theory only provides a partial explanation of the impact of legal climates on foreign investors.

The first piece of research is the most relevant, recent and comprehensive of the studies of foreign investors. The survey was conducted in 2005 on behalf of the Foreign Investment Advisory Council (FIAC) of Russia, a lobby group of

multinational investors. The sample consists of 107 current foreign investors and a further 51 'potential' investors, that is, foreign companies that have not yet invested in Russia; the firms were primarily headquartered in Europe and the United States.

The FIAC study is supportive of the Dominant Theory in so far as it confirms that the foremost concern of foreign investors, both potential and actual, is the legal climate. For example, according to potential investors, the top five barriers to investment include: corruption, administrative barriers, selective interpretation and application of laws and inadequate and inconsistent legislation.[230] Further, the four most frequently cited measures that potential investors recommended that the Russia government undertake in order to attract more investment were, in this order: reduce corruption, increase intellectual property protection, undertake judicial and legal reform, and reduce bureaucracy.[231]

The survey does not support the Dominant Theory unequivocally, and does in fact provide grounds for further research. The survey shows that foreign firms, when prompted to in a multiple choice questionnaire, will identify legal issues as barriers to investment. However, this in itself does not tell us to what extent legal concerns *actually* prevented investment. Firstly, the study is tilted towards legal issues: eleven out of the eighteen response options on barriers to investment were legal factors.[232]

Secondly, the *actual impact* of the legal climate within the broader context of overall perceptions of Russia, is unclear. It seems that the appearance of steps being made in the right direction matter more to investors than the current quality of the legal climate. This can be seen in the fact that almost three quarters of potential investors actually had plans to invest in Russia, despite what they had said about the legal climate.[233] Next, the general optimism of potential investors about Russia compensated for the weaknesses they perceived in its legal climate, for example, 51%

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230 FIAC 2005, 34-35.
231 FIAC 2005, 44-45.
232 FIAC 2005, 34.
233 FIAC 2005, 21.

of potential investors expected Russia's investment climate to improve over the forthcoming two years, while only 18% believed it would get worse.[234]

The final, and perhaps most important reason why we should be sceptical about the extent of harm done by the Russian legal climate lies in the success enjoyed by current investors. Despite their assessments of the Russian legal climate, 40% of foreign investors had seen their profits rise by over 30% in 2004, and a further 33% had seen profits rise between 10-30%.[235] Perhaps unsurprisingly therefore, 78% of investors were planning on increasing their operations in Russia, as against 2% that were planning on reducing them.[236] The Russian legal climate, despite all its problems, is not preventing foreign investors from profiting and succeeding in Russia. This, of course, does not mean that the foreign investors would not welcome improvements in the legal climate, however, it certainly suggests that a Theoretically Ideal Legal Climate is not essential.

The second piece of research is a 1998 survey of foreign investors in Hungary. This identified a "stable legal climate" as the second most important consideration in investment decisions, after obtaining or increasing market share. While 61% of respondents labelled a stable legal climate as "very important" and a further 25% as "important", investors at the same time considered the climate "inadequate". This paradox is typical of this type of research: why do foreigners invest in spite of a legal climate that is in their own reckoning, 'inadequate'? In this case, it may be because other factors, such as "prospects for economic development", the "availability of skilled labour" and a "stable political situation" may have been more decisive. This explanation is in fact supported by the study: if one takes into account whether factors were ranked as either "important" or "very important", the legal climate loses significance, ranking fourth out of six factors.[237]

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234 FIAC 2005, 26.
235 FIAC 2005, 16.
236 FIAC 2005, 17.
237 Elteto & Sass 1998, 10-11.

Both the FIAC and Hungary studies suggest that the Dominant Theory, with the Theoretically Ideal Legal Climate as its axis, does not present a complete impression of foreign investor behaviour in countries with weak legal climates. According to the Dominant Theory these hosts legal climates should be unattractive to investors. What the Dominant Theory fails to explain is why, nevertheless, the very same firms invested in them. The third piece of research, below, also leaves us with this conundrum.

In a survey of foreign investors in Sri Lanka, Perry-Kessaris first found that 52% of investors had not investigated the legal system prior to investing.[238] Further, from the standpoint of the Dominant Theory, foreign investors' assessments of the Sri Lankan legal climate classed it as an unattractive (inefficient and unpredictable) legal climate. Nevertheless, 83% of them would still have invested there if they had known prior to investing what they learned during operations about the Sri Lankan legal system.[239] This suggests, like the FIAC study, that foreign investors have somehow learned to cope, and also indicates that while legal climates may not be theoretically ideal, they may be satisfactory in the eyes of certain investors.[240]

The fourth study is one conducted by the Multilateral Investment Guarantee Agency (MIGA). MIGA is a faction of the World Bank charged with promoting the flow of private foreign investment to developing countries. In 2002, it published a survey about the foreign investment plans of 191 large multinational firms. It is difficult to draw clear conclusions about the importance of the host legal climate from this study. The survey found that the most important factors in site selection were market access, followed by social and political stability. The 'ease of doing business' which was not defined by the study, but probably encompasses regulatory and legal issues to some extent was the third most important factor. More specifically, corruption was

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238 Perry 2001, 90.

239 Perry 2000b, 786; see generally Perry 2001, 93-95.

240 Perry 2001, 125.

the seventh most important issue.[241] When evaluating foreign investment risks, the authors report that the breach of contract and the lack of law enforcement are a "secondary" concern to investors.[242]

The FIAC, Hungary and MIGA studies are examples of the most popular qualitative approach to investigating law and foreign investment – listing barriers to investment. But, as demonstrated in the FIAC study, they cannot be used in support of the Dominant Theory for the simple reason that the method does not indicate whether the legal concerns that are frequently pointed to are actually great enough to alter an investment decision. This is an absolutely critical point. Where the firms surveyed are actual investors rather than potential investors in the country under examination, evidently, the concerns raised were not significant enough to prevent an investment. The next two studies stand out as they identify the extent to which legal concerns actually prevented investments from taking place.

Klavens and Zamparutti conducted a survey of 255 multinational mining, construction and manufacturing firms in 1992. The respondents included both firms considering an investment and those with a current investment. The study focused on whether legal concens relating to environmental issues, such as environmental liability and compliance costs, were an impediment to investment in the Czech Republic, Hungary, Poland and the Slovak Republic. The researchers found that environmental issues are unlikely to prevent investors from considering an investment.[243] However, environmental concerns are "secondary, but critical factors" once companies begin to consider investing in particular plants.[244] In fact, of the 77 firms that had considered and rejected investment opportunities, 41 (53%) said that at least one environmental issue was very important to their decision not to

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241 MIGA 2002, 19.
242 MIGA 2002, 11.
243 Klavens & Zamparutti 1995, 4.
244 Klavens & Zamparutti 1995, 5.

proceed.[245] Though insightful and well designed, the survey's relevance is limited by its narrow scope and age.

The sixth piece of research is a 1996 survey of 26 US firms operating in the Russian Far East. It found that the most common reason why firms had not invested in the region yet was because the legal system was "too ambiguous and fluid." However, this amounted to only 22% of all responses.[246]

The studies that list barriers to investment present a superficial view of the role of law and weaken the claims of the Dominant Theory. Unlike the Klavens & Zamparutti's study, they do not tell us the extent to which concerns about host legal climates actually deterred investors. As such, they cannot be seen as evidence in support of the Dominant Theory. Nor, like the Dominant Theory, do any of these studies explain why the respondents may have invested in spite of the apparent weaknesses they perceived in the legal climates in question. As a welcome response, Perry-Kessaris' study shows that investors may not be particularly well informed about the legal climates of potential hosts, and confirms that legal shortcomings may not affect the decision to invest. In summary, existing research, regression and surveys alike, lack descriptive power, and suggest that the Dominant Theory, which relies on these studies for empirical backing, also lacks a degree of realism.

The limitations in existing research provide grounds for further research, and it is the aim of this study to address the questions left unanswered due to the limitations of existing work. So, what do we need to know that we do not? First, how potential investors perceive and respond to host legal climates in the investment decision process. Second, why foreigners invest in spite the fact that they perceive the absence of a Theoretically Ideal Legal Climate. Third, under what circumstances the legal obstacles are more or less likely to prove a barrier to investment. The next study provides general answers to these questions.

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245 Klavens & Zamparutti 1995, 6.

246 Thornton & Mikheeva 1997, 96.

John Hewko describes his extensive experience as a lawyer in the transition region. Significantly, his work shows that the impact of legal shortcomings is circumscribed by other factors. For example, corroborating our interpretation of the FIAC study, Hewko says that most investors were willing to overlook problems in the legal climate provided they had a 'feel good' perception of the country, while an improving legal climate would not compensate for a declining general perception of the country.[247] He also argues that foreign investors were influenced foremost "by the nature of the business opportunity, the potential for high returns...and an often superficial 'feel' about a country." He contends that while the state of the legal system "was a component of foreign investors' perception, it was generally not the decisive factor in making an investment decision." While his evidence is anecdotal, it is also uniquely insightful in that it describes how perceptions of host legal climates actually affected foreign investors, rather than how it is expected to affect them. The main conclusion to be drawn from Hewko for our current purposes is that the impact of the legal climate on foreign investment is better judged by understanding the role of law in the context of business opportunities and general perceptions of the host country rather than by listing the obstacles to investment.

3 Summary

Although the logic of the Dominant Theory is compelling, it is also somewhat superficial. Foreign investor surveys do indeed show that foreign investors wish that host states possess features of a Theoretically Ideal Legal Climate. Until they are looked at carefully, the regression studies seemingly link foreign investment levels to the quality of host legal climates. Critically, however, the fifteen studies reviewed here fail to show that the perceived quality of host legal climates are *actually a decisive factor* in the investment decision process. In fact, only three of the studies[248] actually address the central question of law and foreign investment, namely: what is the role

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247 Hewko 2002, 8-9.

248 Hewko 2002, Klavens & Zamparutti 1995, Perry 2001

of law in the decision to invest? Instead, the vast majority of the research leaves two questions about the alleged importance of a Theoretically Ideal Legal Climate lingering:

- How do foreign investors perceive the host legal climate before investing?
- Why do foreigners invest in spite of the fact that they perceive the absence of a Theoretically Ideal Legal Climate?

These shortcomings clearly show that the prevailing view in the law and development establishment exaggerates the importance of a Theoretically Ideal Legal Climate and oversimplifies the impact of the law. The next Chapter reviews evidence that helps to address these two questions. In doing so, it provides support for the hypotheses.

Chapter Four:

Why the Legal Climate may not be so Important to Foreign Investors

Introduction

A substantial body of literature exists that does not conform to the Dominant Theory's position concerning the critical importance of a Theoretically Ideal Legal Climate to foreign investors. This Chapter presents this evidence within the framework of the research hypotheses.

Hypothesis One is that "a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia." Three justifications are offered for this hypothesis. First of all, foreign investors may overlook the quality of the legal climate if non-legal factors are much more important, and take precedence in the decision to invest; this is considered in Section 1 by exploring the 'Eclectic Paradigm'. Second, potential foreign investors may not be able to acquire and process accurate information about host legal climates, especially Russia's; evidence supporting this view is discussed in Section 2. Finally, foreign investors may in fact be able to do business successfully in legal climates that lack a Theoretically Ideal Legal Climate, for example by using informal institutions or bribery when the official legal system does not meet their needs; this is discussed in Section 3.

Hypothesis Two is that "foreign investors' perceptions of the Russian legal climate depend on their firm characteristics." In Section 4, evidence is presented to show that the impact of the law depends on the attributes of the foreign investor.

1 The Eclectic Paradigm

According to UNCTAD, it is widely agreed that John Dunning's 'Eclectic Paradigm' is the theory that best explains patterns of FDI.[249] The Eclectic Paradigm is a holistic framework that aims to identify the significance of the numerous factors that influence foreign production by enterprises.[250] The Eclectic Paradigm is valuable to

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249 UNCTAD 1998, 89.

250 Dunning 1988, 1.

us because it provides a much broader perspective on the determinants of foreign investment than that offered by the Dominant Theory. It explains why the quality of host legal climates may be of low importance to foreign investors.

First, a wide range of factors can influence the decision to invest. According to the Eclectic Paradigm, there are three categories of host country determinants that contribute to the attractiveness of the host. In order of importance they are: economic factors, the policy framework and business facilitation.[251] An UNCTAD study cites, across these three categories, thirteen different economic determinants, eight policy framework determinants, and five business facilitation determinants. So, according to one source, at least twenty-six factors might affect the attractiveness of a host. These include attributes as diverse as trade policy, the availability of skilled labour and social amenities.[252]

The second point to note about the Eclectic Paradigm is that the choice of where to invest depends not simply on the attributes of the host, but in fact on how the various characteristics of the foreign firm fits with those attributes.[253] The relative impact of different host determinants will thus depend on at least four firm factors,[254] foremost, the motive for investment. Four motives for investing abroad are identified: resource-, market-, efficiency- and strategic asset-, seeking. Firms motivated by natural resources are classified as resource-seekers. Those that aim to supply the local market are characterised as market-seekers. Firms that aim to reduce costs by moving production abroad are efficiency seekers. Those in search of a particular local asset, such as knowledge, are known as asset-seekers.[255] Other relevant attributes of the foreign firm include the type of investment (brand new or follow-on), the business sector of investment; and the size of investor.[256]

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251 UNCTAD 1998, 91.
252 UNCTAD 1998, 91.
253 UNCTAD 1998, 89
254 UNCTAD 1998, 90-91.
255 Dunning 1998, 50.
256 UNCTAD 1998, 90-91.

Given the multitude of factors identified by the Eclectic Paradigm, it is often difficult to pinpoint the most decisive host country factor in an investment.[257] It is helpful to be conscious of this complexity and breadth when faced with the relatively reductionist and one-dimensional perspective of the Dominant Theory. We can now turn our attention to what the Eclectic Paradigm has to say about host legal climates.

The quality of the legal climate may in principle affect the choice of host, but the Eclectic Paradigm suggests that host legal climates have a limited impact on the investment decision. The quality of the legal climate is not identified as a host country determinant in its own right by the Eclectic Paradigm, but elements of the legal climate do fall under two of the categories of host country determinants, namely, the policy framework and business facilitation. For example, the 'policy framework' for FDI includes the rules regarding the entry and operations of foreign investors and tax policies. The protection of property rights, and the "hassle costs" arising from corruption and administrative efficiency feature within the category of 'business facilitation'.[258]

The core legal concerns that feature in the Dominant Theory, such as the enforcement of property rights, bureaucracy and corruption all fall under the category of business facilitation.[259] However, the point to note is that business facilitation is *not* considered by the Paradigm to be a decisive factor in investment determination.[260] Conversely, legal factors that *are* considered to be important within the Eclectic Paradigm fall outside the scope of the legal climate for our purposes. For instance, the policy framework for FDI is a necessary but insufficient condition for FDI; however, it does not refer to the quality of the legal climate, but to whether foreign investment is actually permitted at all.[261]

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257 UNCTAD 1998, 90.
258 UNTCAD 1998, 91.
259 Dunning 2002, Exhibit 4.
260 UNCTAD 1998, 105.
261 Dunning 2002, Exhibit 4.

The main reason why the quality of the legal climate might be considered to be a determinant of FDI is that the attractiveness of a host country depends in part on the cost of doing business there.[262] As argued in Chapter Two, in so far as the quality of its legal climate can affect the cost of doing business in a host, it may in principle affect the choice of foreign firms to invest. But the Eclectic Paradigm views the costs of the legal climate in narrow terms. According to Dunning, the legal climate imposes costs in so far as inefficient bureaucracy and corruption give rise to "hassle costs."[263]

In summary, the most widely accepted theory of foreign investment determination, the Eclectic Paradigm, suggests that law is not an important determinant of foreign investment. First of all, a multitude of factors – not just the state of its legal system - affect the attractiveness of a host economy. Further, where it does address the host legal climate, the Eclectic Paradigm does not appear to give much weight to the legal issues that the Dominant Theory consider to be important to foreign investors. One of the justifications for Hypothesis One is that non-legal factors may take precedence over legal issues in the decision to invest. The Eclectic Paradigm provides strong support for this argument.

Finally, the Eclectic Paradigm establishes that the attractiveness of the host depends not on its own attributes alone, but on how it fits the with characteristics of the foreign investor. This issue is taken up in greater detail in Section 4.

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262 DUNNING 1993, 66 cited in Perry 2001, 18.

263 Dunning 2002, Exhibit 4.

2 Do Foreign Investors Acquire and Process Accurate Legal Information?

2.1 Introduction

Implicit in the Dominant Theory is the presumption that, when choosing the investment location, foreign investors rationally assess the quality of the potential host legal climate. In order to show that foreign firms follow the decision process implied in the Dominant Theory, it is therefore necessary to demonstrate that, when choosing the host, they make use of accurate information about potential host legal climates. We can advance our understanding of foreign investors and the law by exploring this presumption, which is almost never examined in the FDI literature.[264] This is facilitated by drawing from a broader array of literature than has traditionally been applied in this field. The evidence that is about to be presented shows that, in some circumstances, foreign firms may neither be willing, nor able to be acquire and process information in the manner suggested. The evidence also shows that in contrast to the objective model implicit in the Dominant Theory, there exists a notable degree subjectivity and consequent diversity in the perceptions that foreign firms have of host legal climates.

The problems of the Dominant Theory stem from the limitations in the underlying theories of law and economics. Traditional law and economics is largely based on the standard assumptions of neoclassical economics.[265] These assumptions are that human choice involves the maximisation of satisfaction (commonly referred to as 'utility'), a stable set of preferences to choose from, and an optimal level of information upon which to base a decision.[266] Thus humans are expected to demonstrate 'global rationality.'[267] These assumptions, though useful, are often found in practice to be false.[268]

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264 Perry 2001 is the only exception.
265 Jolls *et al.* 2000, 49.
266 Becker 1976, 110-112.
267 Simon 1997, 17.
268 Jolls *et al.* 2000, 50.

Leading figures in economics have questioned whether actual behaviour resembles that of the 'homo economicus' just outlined. Even the founder of transaction cost thinking disagreed with the economic assumptions of human behaviour. Coase famously stated that "the rational utility maximiser of economic theory bears no resemblance to the man on the Clapham bus or, indeed, to any man (or woman) on any bus."[269] He was disdainful of the abstract models of economics he referred to as "blackboard economics."[270] North also expresses dissatisfaction with the behavioural assumptions of neoclassical economics. He argues that further progress in social sciences requires that these assumptions be abandoned.[271] The final figure in this trio of economists with Nobel Prize winning credentials is Herbert Simon, who introduced the idea of 'bounded rationality'.[272] Bounded rationality argues that decisions are constrained by limitations in the knowledge, computational capacities and skills of decision makers.[273] Bounded rationality has even bred a school of thought known as 'behavioural law and economics', which aims to explore the implications of actual, rather than theoretical human behaviour for the law.[274]

Neither this critical view of classical economics, nor behavioural law and economics in particular appear, however, to have penetrated mainstream law and development thinking, let alone the debate on law and FDI. To their credit, the World Bank has recently acknowledged that behavioural law and economics demonstrates that individuals are not 'rational' in their attitudes to risk and uncertainty.[275] However, to my knowledge, law and development scholarship has yet to systematically address the work on bounded rationality and behavioural law and economics. Their work is germane, in so far as it provides theoretical foundation for evidence that is not explained by the Dominant Theory. The following sub-sections will show that foreign firms' ability to make objectively rational decisions about host legal climates

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269 Coase 1988, 3.
270 Coase 1988, 19.
271 North 1990, 17.
272 Jolls *et al.* 2000, 14.
273 Simon 1997, 18.
274 Jolls *et al.* 2000, 14.
275 World Bank 2004, 47.

is limited by their ability to *acquire* and *process accurate information* about host legal systems and legal risk.

2.2 The Availability of Information

The FIAC foreign investor survey of Russia picked up on the question of the acquisition of reliable information as an issue in the investment decision process. It found that 59% of potential investors felt that they did not have access to enough credible information about Russia in order to make an informed investment decision. Moreover, the 'legal base' was the issue that most investors (66%) felt they lacked credible and necessary information on.[276] Why might they lack such information?

The collection of information imposes costs, and so with scarce time and resources, decision makers may remain ignorant because it is too costly to be fully informed.[277] Legal systems in transition countries have undergone over a decade of change which continues today,[278] and therefore it may be difficult or costly to remain informed about one's legal standing and rights, which may in fact change over the time that an investment is being considered. Indeed, firms perceive that the Russian legal climate is marked by instability and a lack of clarity.[279] Finding information about potential investment targets or partners is particularly difficult in Russia as a large number of Russian firms fall significantly short of international standards on the disclosure of information, making it hard for foreigners to assess their rights.[280] Indeed, the FIAC study found that 50% of current foreign investors felt that they lack credible and necessary data on Russian companies.[281]

This informational barrier may be exacerbated in cases where the written rules do not accurately reflect the course of action usually taken. The gap between the law on

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276 FIAC 2005, 46-47.

277 Kasper & Streit 1998, 54.

278 EBRD 2002a reviews the decade of legal reform; see generally, the EBRD's *Law in Transition.*

279 Ahrend 2000; EBC 2003, 21 & 31.

280 OECD 2004, 23.

281 FIAC 2005, 47.

the books and law in practice is a feature of transition legal systems, including Russia's.[282] Further, there is evidence (presented in subsection 3.2 of this Chapter) that practices across a broad spectrum of jurisdictions are influenced heavily by informal norms, rather than just by formal laws and legal enforcement; this is especially true in Russia. Even detailed and rigorously compiled sources of information on legal climates, such as the World Bank's Doing Business database, can be criticised for not taking the impact of informal practices into account.[283] So, the ability of foreign firms to be accurately informed about what goes on in host legal climates will be limited in so far as actual practices deviate from official information and procedures.

In Russia's case the informational barrier is so significant that it has been repeatedly observed that foreign firms may have biased and unrealistic views of it as an investment destination. In the FIAC survey, 66% of current foreign investors reported that non-investors perceptions of Russia were more negative than the 'reality' in Russia.[284] In another study, leading western managers in New York, London and Moscow were interviewed. The main finding of this study was of a "qualitative difference" in the perceptions of the Russian investment climate among westerners outside the country and those actually working inside Russia; again those outside the country had significantly worse opinions.[285] A further survey of foreign investors in Russia also concludes that opinions within Russia about the investment climate there are more positive than outsider perceptions.[286] This gap between pre-investment and during-investment perceptions seems to be a significant, yet generally overlooked aspect of foreign investment determination. It has a particular bearing on countries such as Russia, that have stereotyped image abroad.[287]

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282 EBRD 2002a, 15; Bevan *et al.* 2004, 50.
283 Djankov *et al.* 2001.
284 FIAC 2005, 37.
285 SRU Limited (UK) & Expert Information Group (Russia) 2003.
286 Ahrend 2000, 11.
287 For example, see The Moscow Times 2004b, 2004c, 2004f.

Either for reasons of the infeasibility of acquiring in-depth information or because investors simply are not interested enough, there is evidence that foreign investors in the region may rely on quite superficial information in their decisions. Hewko argues that foreign investors' perceptions were:

> "rarely based on a thorough understanding of the political, social, legal, and cultural situation in the country, but rather on information obtained from television news reports back home, anecdotes from previous trailblazers, perceptions as to what their competitors were thinking and doing, or an article read in the *International Herald Tribune* during the flight over."[288]

Similarly, Perry-Kessaris found that only 48% of foreign investors surveyed had actually investigated the Sri Lankan legal system prior to investing; moreover, she characterises the method for investigating the legal climate by half of these firms as "superficial".[289] The study further contests the idea that foreign investors pay any material attention to the legal system by finding that those who had investigated the legal system were just as likely to be surprised by it, once operating in the Sri Lanka, than those who had not.[290] A MIGA survey also found that, prior to investment, multinationals primarily relied upon general economic information about countries and then information about foreign investment laws and regulations. The general quality of the legal climate did not feature as an information source for FDI decisions.[291]

Economic theory assumes that choices are invariant to the manner in which information is presented, and that the media therefore has no impact. Bounded rationality, however, asserts that 'presentation effects' exist, and so "people are likely to think, mistakenly, that salient events are more common than equally prevalent but

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288 Hewko 2002, 8.
289 Perry 2001, 89-90.
290 Perry 2001, 91.
291 MIGA 2002, 30.

more subtle ones."[292] This may explain why isolated but attention-grabbing events are deemed to have such an influence on Russia's investment prospects. For example, BP's high profile investment in Russia, valued at over $6bn, is widely considered to have had a significant and positive impact on foreigners' perceptions of Russia, with the symbolic meaning that Russia had become a viable investment destination.[293] In sharp contrast, however, the infamous 'Yukos affair',[294] is widely thought to have ruined the nascent improving image of Russia in foreign business circles and media.[295] It also explains why combating the negative image of Russia in the west is among the country's top FDI policies, and was initiated by President Putin himself.[296] Interestingly, foreign investment advisors have raised quite cosmetic issues in their attempts to attract FDI into Russia. For example, the European Business Club drew attention to Moscow's main international airport, which in their words "continues to be the main source of the negative image of Russia for people coming to Moscow."[297]

2.3 Information Processing Constraints

In addition to not being always able to acquire reliable information, foreign firms may also not be able to process information about legal climates in the presumed 'rational' way. Research on decision making has shown that individuals often rely on heuristics, or rules of thumb, to simplify decisions,[298] especially where there is high uncertainty.[299] Other factors, such as emotions and intuition also affect the decisions of entrepreneurs.[300] These constraints and influences on computational capacity may explain why "businessmen often sign contracts without understanding their legal implication, state risk without knowing their legal liability, or invest in property

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292 Jolls *et al.* 2000, 50-51.
293 Citibank 2003, The Moscow Times 2004g, Doyle 2003.
294 Discussed in Chapter Six.
295 For example, The Moscow Times 2004f, The Financial Times 2004b.
296 The Moscow Times 2004b, 2004c.
297 Remmes 2002, 6.
298 Jolls *et al.* 2000, 15.
299 Posner 1995, 442-443 cited in Perry 2001, 45.
300 Horide 2003, 5 and 9.

improvements without knowing their ownership rights."[301] Hewko argues that foreign investors in the transition did in fact fall back on such rules of thumb:

> "In short, most foreign investors were willing to accept or ignore actual problems in the legislation and legal system if they had a visceral 'feel good' perception of the target country. Conversely, if the general perception of a country were to decline, foreign investors would be more hesitant even if, on paper, the state of the legal system were actually improving."[302]

It is also possible that businessmen may be uninterested in gathering information about the legal system because the business case has already been settled, or that they even selectively gather information to merely justify the business case.[303] Further, the process of decision-making can also be greatly affected by the methods to collect and analyse information about the host state.[304] We should bear in mind that many sources of information about hosts have a vested interest in encouraging investment, for example, investment promoters, local and international law firms, chambers of commerce or regional investment boards.

2.4 Summary

The Dominant Theory presumes that foreign investors both possess and rationally assess accurate information about host legal climates during the decision to invest. However, for a variety of reasons, foreign investors may not, in the objective and thorough manner supposed, acquire and process in-depth information about legal climates at the time when they are determining the host. The evidence presented suggests that the Dominant Theory is unrealistic in its representation of how foreign investment decisions are made. While the studies reported in the two sub-sections above do not conform to the Dominant Theory, it is important to note that they are readily explained by academic disciplines outside of classical law and economics.

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301 Cooter 1997, 102.
302 Hewko 2002, 8.
303 Perry 2001, 45.
304 Aharoni, 1966, 15.

This Section has thus provided evidence in support of Hypothesis One. Further research on the role of information in the decision to invest is warranted. Section 3 provides the final justification for Hypothesis One. It considers how foreign investors may operate successfully in the absence of a Theoretically Ideal Legal Climate.

3 Alternatives to a Theoretically Ideal Legal Climate

The final reason why legal systems might have a limited impact on the decision to invest is that foreign firms may be able to achieve the efficiency and predictability they desire outside of the formal legal system. Bribery, channels of influence and informal institutions can serve as substitutes for a Theoretically Ideal Legal Climate, enabling foreign investors to operate successfully in countries like Russia.

3.1 Corruption

3.1.1 Introduction

The Dominant Theory holds that foreign investors expect a regulatory regime that operates like a "vending machine"[305] – automated, impersonal and efficient. In contrast, states and institutions, which can be referred to as 'permeable', may allow individuals to access and influence them.[306] In such environments, investors can obtain the certainty and low transaction costs they seek by taking advantage of the discretion available to public officials. As a result, the legal system can discriminate in the investors' favour.[307] And so, while bureaucratic discretion is perceived in general terms as a source of uncertainty for investors, one must bear in mind that "decisions which may appear to be arbitrary to some may be perfectly predictable to others."[308] Indeed, the evidence shows that foreign investors can be highly pragmatic in their approach towards permeable legal systems.

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305 FIAS 2001, x.
306 Perry 2001, 67.
307 Perry 2001, 67-68.
308 Perry 2001, 70.

In their analysis of transition investment climates, the World Bank has identified three types of corrupt private sector–state relationship: *state capture, influence* and *administrative corruption*. State capture is defined as shaping the formation of the basic rules of the game, such as laws, regulations and decrees, by means of illicit and non-transparent payments to public officials. Influence refers to the firm's capacity to shape the rules of the game, not by means of payments, but as a result of factors such as firm size, and connections with public officials. Administrative corruption is defined as private payments to public officials to distort the prescribed implementation of official rules and policies.[309]

A recent World Bank study showed that foreign investors in the transition region, far from importing higher standards and refraining from corruption, as was commonly thought to be the case, were actually highly involved in corrupt practices. First, they were found to be as likely to be engaged in administrative bribery as domestic firms. Second, they are almost twice as likely to be involved in state capture. Third, foreign investors were found to have made considerable direct performance gains from corruption. This led the researchers to conclude that foreign investors were amongst the greatest beneficiaries of corruption in the region during the period.[310] Hewko also observes that opaque and corrupt systems were at times "highly desirable" to individual foreign entrepreneurs, especially those with good connections.[311]

3.1.2 Ethical Challenges

While foreign investors may prefer that hosts be free from corruption, in corrupt environments, they may not have a real choice, and may react pragmatically. Foreign firms are faced with the dilemma of either missing business opportunities altogether, trying to pursue opportunities without paying bribes, or paying bribes.[312] The most

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309 Hellman *et al.* 2000a, 2.
310 Hellman *et al.* 2002, 3 & 11-12.
311 Hewko 2002, 10.
312 Bray 2005, 114-115.

ethical response is to refuse to invest. The difficulty in taking such a stance is that the firm will miss an investment opportunity, an outcome which is unlikely to be taken lightly. Instead, they may continue with their investment, but decide to not resort to bribery, in which case they may find it hard to compete. A company's size and its importance to the community may enable it to act ethically and profitably.[313] One argument is that large firms are in a better position to avoid paying bribes since they can publicly announce that they will not pay bribes. If this policy is followed, the argument runs, government officials will come to know that there is no point in asking employees of that firm. There is anecdotal evidence to support this argument.[314] Moreover, firms that are perceived as ethical may have an advantage as they are more trusted.[315]

Foreign investors may also choose to pay bribes where necessary. The payment of bribes may not be considered as necessarily unethical. According to Donaldson, a business ethicist, administrative bribery is acceptable on four conditions: first, that it is "accepted" in the host country; second, that it is "necessary" for successful business; third, that it does not violate any fundamental rights; finally, if the practise violates a norm of the home country of the foreign firm, then the firm should "make its disapproval of the practise known."[316] Donaldson's approach readily sanctions administrative bribery, since the key conditions of 'accepted in the host country', and 'necessary for successful business' are so subjective.

The existence of petty corruption, in the guise of 'facilitating payments', may not pose an ethical dilemma for foreign investors that would alter an investment decision. Facilitating payments are bribes "paid to receive preferential treatment for something that the bribe receiver is required to do by law".[317] Typical examples are the expedition of applications or the clearing of goods in customs. These do not

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313 De George 1993, 134
314 Donaldson 1989, 146-467; Financial Times 2001.
315 Donaldson 1989, 147
316 Donaldson 1989, 104-105
317 Transparency International Internet Site

attract so much opprobrium as other forms of bribery, such a kick-backs, since they do not induce the bribe taker to alter a decision, or to violate a norm or law, but instead, perform "routine government action". It is felt that in developing countries especially, government officials have to be paid a little extra to do their jobs, and that salaries may be deliberately set low with the practise in mind.[318] Interestingly, the US Foreign Corrupt Practises Act of 1977, which prohibits US firms from bribery abroad, actually permits facilitative payments.[319] To conclude, therefore, the appearance of petty corruption in a host may not prevent an ethical and law-abiding foreign investors from investing there.

3.1.3 Corrupt Practises

By engaging in corrupt practices, foreign investors run certain risks, for example being black-mailed, exposed or subject to legal action. A common way in which foreign firms manage these risks is by employing a local agent as an intermediary. By using intermediaries foreigners firms may not know or can claim they do not know about payments made on their behalf and they can therefore deny involvement.[320]

Local affiliates are particularly useful to investors in unfamiliar business environments, especially ones that lack transparency.[321] It is said that foreign investors seek out joint venture partners with political connections,[322] as well as those who understand how business in done and have the necessary contacts to facilitate business.[323] They will also recruit local staff who are familiar with what actually happens within the legal climate, rather than what is supposed to happen.[324] According to one foreign investor the actual tax burden in Russia depends very

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318 Donaldson 1989, 104. Financial Times 2001.
319 US Department of Justice, Foreign Corrupt Practises Act.
320 Bray 2005, 112-115.
321 Bray 2005, 114.
322 Charman 1998, 16.
323 Hellman *et al.* 2002, 16 and Bray 2005, 115.
324 Bray 2005, 115 and Perry-Kessaris 2005, 176.

much on the firm's connections, with well-connected businesses able to significantly reduce their tax bills.[325]

3.2 Informal Institutions

Informal institutions are another feature of actual, rather than Theoretically Ideal institutional environments, which prompt a rethink of the Dominant Theory. Perry-Kessaris argues that the impact of institutional failings on foreign investors depends on the ability of firms to find substitutes for weak formal institutions.[326] As the overall institutional setting is a mixture of formal and informal, focusing exclusively on the role of formal legal systems results in a partial impression of the impact of legal systems. The Dominant Theory does not take informal institutions into consideration at all; in the previous Chapter, the FDI regression studies were criticised for excluding them.[327]

The most relevant attribute of informal institutions is that they facilitate economic exchange where formal - that is state institutions, do not function or are inefficient.[328] The use of informal institutions is conventionally explained quite simply in terms of transaction costs: the higher the costs of formal institutions, the more likely parties are to likely to rely on informal ones.[329] They can be characterised as the "market response" to the failure of the state to provide and enforce laws.[330]

Accordingly, a certain amount of the actual implementation of the law in transition countries is carried out by informal institutions.[331] Informal forms of law enforcement in Russia can range from social norms and pressures to arbitration, private yet legal protection agencies and organised crime.[332] Informal institutions can define property

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325 Russian Economic Trends 1999, 7.
326 Perry 2001, 40.
327 Chapter 3, Section 1.1.1.
328 World Bank 2002b, 171-173.
329 North 1990, 68; Bueno de Mesquita & Stephenson 2003, 28.
330 Hay & Schleifer 1998, 399.
331 Estrin & Meyer 2004, 340 and Gel'man 2001, 10.
332 Hay & Schleifer 1998, 399.

rights and enforce contracts.[333] The OECD recently observed that arbitrariness of law enforcement in Russia leads individuals to rely on informal networks and contacts to obtain results which should, in a Theoretically Ideal Legal Climate, be obtainable or guaranteed.[334] They have also served to resolve disputes in Russia's stock and commodity exchanges.[335] Thus, the first point is that they 'fill the gaps' in formal systems.

Second, especially in the Russian context, informal practices intersect with official rules, laws and institutions.[336] For example, a study on the investment climate in Russia finds that it is common for the private sector and the bureaucracy to negotiate over the application of building regulations, often via a third party.[337] Third, informality does not necessarily imply corruption, but in some cases, informal practices do involve bribes.[338] The final point to note about informal institutions is that, by their very nature, they are not directly amenable to policy, as they are not within the immediate grasp of the state.[339]

Empirical research in legal contexts as diverse as Russia and the US shows that people tend to use formal law and legal enforcement much less than previously assumed, and instead structure their transactions or resolve their disputes using elaborate informal means. Ellickson and Macaulay provide two classic examples of the use of informal institutions in the US. In the early 1960's, Macaulay surveyed local American firms and found that their commercial relationships were not governed by tight rules. Litigation and reference to legal agreement between parties was extremely limited, and lawyers were brought into the dispute settle process as a last resort.[340] Ellickson explains that social norms take precedence over formal

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333 World Bank 2002b, 173.
334 OECD 2004, 60
335 Hay & Schleifer 1998, 399.
336 Pastukhov 2002.
337 Foreign Investment Advisory Service 2001, Chapter Three, pages 56, 64.
338 Wang 2001, 536-537.
339 Raiser 1997, 2 and North 2001, 329.
340 Macaulay 1962 cited in Perry 2001, 41

dispute resolution among people with close social ties. Ellickson studied disputes between cattle ranchers and farmers, and found that their disputes were usually resolved by appealing to generally accepted social rules, not by bargaining over legal rights, even though these existed.[341]

Where gaps exist in the formal legal system, informal systems enable markets to function. Thus one would expect to find a significant degree of recourse to informal mechanisms in transition countries. Indeed, studies conducted on the nature of contracting in the region echo the main findings of Ellickson and Macaulay.

Johnson and colleagues surveyed the contracting strategies of over 1400 firms across Poland, Slovakia, Romania, Russia and Ukraine. They found that the basis for most contracts is 'relational'. This is where the relationship between contractors itself induces cooperation, and where the sanction for breach of contract is the loss of trade that results from breaking off the relationship.[342] Research of a similar type conducted on over 300 Russian firms by Hendley *et al.* also found that firms rely heavily on direct negotiations between contractual parties, long term relationships and trust.[343]

Interestingly, legal systems do not need to be perceived as strong for firms to benefit from them. Firms in the Hendley *et al.* study perceived the courts as ineffective, ranking the lack of enforcement as the primary obstacle to submitting disputes to court. Nevertheless, the threat of litigation was used by 71% of firms as a way of dealing with problem customers, and this was regarded as a relatively effective strategy. Further, respondents generally felt that improvements in judicial enforcement would do little to persuade firms to seek out new contractual partners.[344]

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341 Ellickson 1991.
342 Johnson *et al.* 2002.
343 Hendley *et al.* 2000.
344 Hendley *et al.* 2000.

What these examples show is that alternatives to a rules based system can compensate for institutional weakness. In this way, countries might attract and support foreign investment without what is conventionally perceived as a sound formal legal climate. Three studies, to my knowledge, touch on the role of informal institutions in supporting FDI. The most extensive study is by Hongying Wang. Wang concludes that *guanxi,* informal Chinese social networks, explain the country's phenomenal FDI record in the absence of what Upham refers to as a legal system "worthy of the name."[345] Wang shows that guanxi compensate for weak state institutions, enabling foreign investors to protect property rights, resolve disputes, gain access to formal legal mechanisms and navigate "ambiguous and even contradictory" Chinese laws and policies.[346] Hewko claims that as a result of good connections and knowledge of how to exploit the lack of structure in transition countries, legal considerations were not necessarily a barrier or even relevant to the investment activities of some small foreign entrepreneurs.[347] Finally, in a study in India, Perry-Kessaris finds that some foreign investors avoid using the state courts, and instead rely upon negotiation, arbitration and lobbying.[348]

Perry-Kessaris draws attention to the cultural dimension in the choice of using informal mechanisms.[349] Networks of personal relationships, trust and reciprocity are important to East Asian economic activity.[350] For example, Wang argues that ethnic Chinese who live abroad will be advantaged in resorting to personal networks for foreign investment in China. She also points out that foreigners who are accustomed to working in countries lack the rule of law will be advantaged in China, as they will have already acquired an understanding of how to deal with uncertainties and protect their interests in similar environments.[351] In Russia, many firms have maintained relationships with commercial partners from the Soviet era, despite the

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345 Upham 2002, 13.
346 Wang 2000, 535.
347 Hewko 2002, 10.
348 Perry-Kessaris 2005, 175.
349 Perry 2001, 40-41.
350 Gray 1998, 169 & 183-185.
351 Wang 2001, 542-543.

freedom they have to choose their partners since the end of the central planning.[352] Informality and disregard for state institutions and the law are features which have characterised Russian political culture prior to the Bolshevik revolution and up to the present day.[353] But in the West too, the persistence of informality reflects the interpersonal nature of business, and the desire for flexibility.[354]

It is argued that informal institutions have two potential limitations. First of all, they are 'biased' against new market entrants, who do not have the connections required to enter the social networks. Second, being rooted in interpersonal relations, it is thought that they are not 'scaleable'.[355] But the example of China would appear to refute these arguments. Foreign investors are very much outsiders, China is a huge economy (GDP of $2.2 trillion in 2005), very successful in attracting FDI ($54.9 billion in 2004) and continuing to grow at an impressive rate (9.9% in 2005), making the first two suppositions hard to justify.[356] Indeed, Wang confirms that in China, personal networks are open to a wide range of people, including foreigners.[357] However, she does identify some drawbacks to personal connections. Investments which rely on connections with particular individuals can suffer if these individuals lose power or change positions. Further, she points out that developing good relations with all the relevant actors can be difficult and expensive.[358]

As mentioned already, the use of informal institutions is traditionally justified in terms of transaction costs. Campbell and Picciotto, however, caution against reducing transactions merely into a question of costs, and stress the importance of the

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352 Gray 1999, 62 cited in Perry 2001, 40 and Hendley *et al.* 2000, 638.
353 Ledeneva 2001, 11-12.
354 Miller *et al.* 1997, 26-29 cited in Perry 2001, 41.
355 World Bank 2002b, 172 & 176 and Wang 2001, 538.
356 World Bank Country Profile, Available online at http://www.worldbank.org/data/countrydata/countrydata.html
357 Wang 2001, 539.
358 Wang 2001, 544.

social aspects of transactions.[359] Informal institutions exemplify how transactions are embedded within social relations.

According to Ellickson, traditional law and economics exaggerates the role of the law by analysing legal problems outside of a social context.[360] Ellickson was not referring to foreign investors and the law, but this Section clearly shows that his arguments are applicable in the present arena. By not taking the role of informal institutions, corruption and influence into account, the abstract approach of the Dominant Theory exaggerates the importance of the law to foreign investors. Ellickson also identifies the findings of behavioural law and economics as an example of the "lacunae" in classical law and economics.[361] Indeed, as explained in Section 2 of this Chapter, it is behavioural law and economics that explains why foreign investors may not conform to economic rationality in the way that they acquire and process information about legal climates. These points lead us to conclude that the Dominant Theory, owing to its abstract perspective, exaggerates the importance of host legal climates to foreign investors.

3.3 Summary

The discussion of informality and corruption demonstrates how economic actors, including foreign investors, react pragmatically to hosts that lack a Theoretically Ideal Legal Climate. In some cases, foreign investors may have no effective choice but to step outside of the formal legal system. It has *not* been argued, and is *not* contended, that informality and corruption are therefore preferable to a Theoretically Ideal Legal Climate, nor that they provide a comprehensive alternative to formal practices. These points are not even relevant to our discussion.

What is relevant is that these practices demonstrate the means by which foreign investors can operate successfully without a Theoretically Ideal Legal Climate,

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359 Campbell & Piccioto 1998, 253.
360 Ellickson 1998, 540.
361 Ellickson 1998, 539 footnote 8.

demonstrating how hosts with weak legal climates can attract and support foreign investment. This point is notable from the perspective of the host country, as legal reform can be a very slow and difficult process, an issue which shall be dealt with in Chapter Six. Attitudes towards such practices may also be expected to vary according to the characteristics of the firms, especially their size and culture. The preceding discussion shows that there are grounds for investigating how informality, influence and corruption affect the alleged importance of the quality of Russia's legal climate to foreign investors.

4 The Attitudes and Characteristics of the Foreign Investor

The assessment of risk is inherently perceived and subjective. Investors make decisions based on their perceptions of reality, rather than an 'objective' reality. Hence, it is "meaningless and fatally misleading to speak of probability, in the objective sense, that a judgement is correct." It is the interpretation of information by the foreign investor, rather than an apparently objective and neutral assessment that matters.[362] As a result we may expect to encounter differences in the attitudes of foreign firms towards legal risk. The evidence in this Section demonstrates that such attitudes depend on the attributes of the foreign investors.

There is growing evidence in the law and development literature that firm characteristics affect attitudes towards law and uncertainty.[363] However, the Dominant Theory does not account for such differences. The characteristics of foreign investors are notable as they determine both attitudes towards law and uncertainty in general, and also, the perceived impact of host legal climates. Here, evidence regarding the influence of foreign investors' characteristics is mainly drawn upon, and there will also be selective use of findings about the characteristics of

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362 Knight 1921 quoted in Perry 2001, 43.

363 The role of firm characteristics, in particular, size in the relationship between firms and legal systems, features in the following works: World Bank 2004b, Batra *et al.* 2002, Beck *et al.* 2002, Solymossy 2002, Perry 2001, Hellman & Schankerman 2000, Smazynka & Wei 2000.

(domestic) firms generally. Three characteristics of foreign investors appear to have an influence in the decision to invest: size, factors relating to the investment, and culture.

4.1 Size

There is no consensus as to how firm size affects foreign investors' attitudes to legal risk. A survey of foreign investors in Russia found that problems faced in Russia were common to all firms, though large industrial foreign investors expressed greater concerns about the tax authorities.[364] Perry-Kessaris' work demonstrates that attitudes towards the legal system in Sri Lanka may depend on investment size; in particular, she finds that the quality of host legal systems are less likely to be a decision factor for smaller firms.[365]

In contrast to these findings, the most common view is that smaller local firms are more prejudiced by weak legal systems. For example, Beck *et al.* show that the extent to which legal obstacles to business and the level of corruption affect a firm's growth depends on its size, with the smallest firms being consistently the worst affected.[366] Also, the World Bank reports that better judicial efficiency benefits smaller and newer unaffiliated firms the most.[367] This point is reiterated by Kolodko who also argues that property rights protection is crucial for the success of SME development.[368] Vandevelde extends these principles to foreign investors, claiming that states that wish to attract more risk averse investors, such as SMEs, would benefit the most from reducing the risk to investors.[369]

Hewko takes a slightly different stance. He argues that transition legal climates posed the biggest problem for medium sized foreign investors, affecting their

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364 Ahrend 2000, 10.
365 Perry 2001, 145-151.
366 Beck *et al.* 2002, 2.
367 World Bank 2002b, 119.
368 Kolodko 2000, 283.
369 Vandevelde 1998, 526.

investment decisions the most. The reason being that in general, medium sized investors were too large to rely on the informal practices used by individual entrepreneurs, but too small to have the resources required to deal with the challenges posed by host legal systems.[370] Further, compared to large multinational investors, an investment in transition economies accounted for a larger share of their capital, and therefore failure would have more adverse consequences for them. Finally, the weakness of the legal climate had less impact on smaller firms in the region as such investors avoided relying on it and instead used informal institutions, influence and bribery.[371]

4.2 Investment Related Factors

The impact of the host legal climate has been found to also depend upon two factors relating to the investment itself: the mode of entry and investment motivation.

4.2.1 Joint Ventures

Undertaking a joint venture is a strategy that firms can choose to employ to alleviate the challenges of investing in unfamiliar or difficult environments. This may explain why, in the FIAC study, "joint venture" was the most popular response to the question: *"if your company were to enter the Russian market, what might be your preferred entry strategy?"* In her study of foreign investors in India, Perry-Kessaris also found that foreigners were able to limit their engagement with the Indian legal system by relying on local partners.[372]

The more adverse the local conditions, the greater the premium on a associating with a reliable partner. For example, Wei and Smarzynska show that in the transition region in the early 1990s, increased levels of corruption were associated with higher probabilities of foreign investors taking local partners.[373] In the same way, Lankes

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370 See also Perry 2000b, 793.
371 Hewko 2002, 10 and Perry 2000b, 792-793.
372 Perry-Kessaris 2005, 176.
373 Smarzynska & Wei 2000.

and Venables found that a small reduction in country risk had a dramatic effect on the preference for full ownership over of joint-ventures in Eastern Europe and the Former Soviet Union.[374] In fact, respondent firms explicitly confirm in the survey that they view the joint venture as an effective risk-mitigation device.[375] Similarly, one of the interviewees in Perry-Kessaris' Sri Lanka study stated that the quality of the legal system did not matter if the firm has enough confidence in the local partner.[376] Finally, in a different study, a number of foreign investors argued that the choice of local partner in Russia can be the single most important factor in the success of a investment partnership.[377]

Interestingly, there is also evidence that points to opposing principles: that foreigners with joint ventures find the legal climate *more* challenging. For example, Perry-Kessaris' survey findings show that foreign investors in Sri Lanka who had taken local joint venture partners expected to be more prejudiced by the legal climate: they were twice as likely to report to be deterred by a legal system that did not conform to the theoretical ideal.[378] They were also more likely to be surprised by features of the legal climate.[379] This may simply echo the point that firms that are sensitive to the quality of host legal climates respond by taking local partners. Finally, in Russia, there is a widespread feeling that joint ventures partners often become the cause of legal insecurity, as they have been known to abuse the relationship and defraud foreigners of their stake in the joint enterprise.[380]

4.2.2 Investment Motivation

According to Dunning, the impact of the institutional environment on the choice of host depends on the motive for investment. As noted in Section 1, within the framework of the Eclectic Paradigm, he identifies four motives for investing abroad:

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374 Lankes & Venables 1997, 560.
375 Lankes & Venables 1997, 560.
376 Perry 2001, 93.
377 Thornton & Mikheeva 1997, 109.
378 Perry 2001, 155.
379 Perry 2001, 155.
380 For example, EBC 2003, 31; Black & Tarrasova 2002, 15; Thornton & Mikeeva 1996, 10.

resource-, market-, efficiency- and strategic asset-, seeking.[381] Dunning notes that 'institutional competence' is relevant to market seekers, but not resource-, efficiency-, and asset-, seeking investors.[382] So the legal climate is deemed to be an issue, for example, for those tapping Russia's consumer market, not its oil and gas reserves. Verifying Dunning, one survey found that the obstacles faced depended upon whether firms were engaged in production or sales, with the latter, market seekers, suffering more heavily from tax and customs authorities and payment arrears from Russian clients.[383] Perry-Kessaris also found that the quality of the Sri Lankan legal system was less likely to be a decision factor for export-orientated foreign investors than for host domestic market seeking investors.[384]

It is generally felt that foreigners that invest with the intention of exporting their goods are less engaged with and therefore concerned about the quality of the host legal climate. A regression study published by the World Bank found that export-orientation was the single most important explanatory variable for FDI flows across developing countries, eroding "substantially" the influence of socio-political risk.[385] This suggests that export-orientated investors, perhaps because they operate in export-processing zones, are to some extent insulated from the host country's legal and political turbulence. This explanation is given support by Perry-Kessaris' interviewees, who explained that export-orientated investors do not come into contact with the local legal system, and therefore its failures are less of a concern to them.[386] Finally, a study of foreign investors in Hungary also showed that the motives and deterrents for investors, including legal risk, depended on whether they were exporting or selling locally.[387]

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381 Dunning 1998, 53.
382 Dunning 1998, 53.
383 Ahrend 2000, 7.
384 Perry 2001, 159.
385 Singh & Jun 1995, 20.
386 Perry 2001, 152.
387 Elteto & Sass 1998, 12.

4.3 Culture

Another of the Dominant Theory's shortcoming is that it does not acknowledge the fact that cultural values affect perceptions and expectations of legal systems. This has been demonstrated by Perry-Kessaris' synthesis of the path-breaking work of sociologist Geert Hofstede. Following Perry-Kessaris, here 'culture' refers to the "values that economic actors carry with them as a result of their personal experience, and according to which they make economic decisions."[388]

Astonishingly, Hofstede survey is based on 116,000 questionnaires sent out IBM employees across fifty countries in 1968 and 1972. He found that attitudes towards uncertainty, levels of individualism, and attitudes towards the distribution of power, all varied according to the employee's nationalities.[389] Perry-Kessaris demonstrates that the importance attributed to legal systems and the features desired of legal systems by economic actors depends on their culture, and can be affected by the three variables mentioned. For instance, attitudes towards state involvement in the economy and the application of discretion are likely to depend on the level of individualism versus collectivism of a society, as well as its sense of how power should be distributed;[390] attitudes towards contracting also depend on the individualism versus collectivism of a culture;[391] and laws will tend be more precise in countries which have a lower tolerance for uncertainty.[392]

A cultural approach to legal systems shows that one cannot assert that a single form of legal climate is universally attractive to investors, even the rich country investors a host country may wish to attract. Perry-Kessaris shows that substantial differences across the three cultural dimensions arise among western industrialised countries, such as the US, UK and France, as well as between Asian industrialised economies

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388 Perry 2002, 290.
389 Hofstede 1980.
390 Perry 2002, 300-302.
391 Perry 2002, 299-300.
392 Perry 2002, 296-297.

like Japan, Hong Kong and Taiwan.[393] The World Bank has recently acknowledged that differences in attitudes to uncertainty exist between national cultures.[394] However, this has not led them to a reappraisal of the Dominant Theory.

The literature on FDI also identifies the impact of culture. According to Dunning's 'Eclectic Paradigm', attitudes to risk and uncertainty and the cultural ethos of a firm can have an impact on investment decisions.[395] One reason for this is that geographical and cultural distance are thought to increase transaction costs and risk, for example, because they affect the personal relations and linguistic barriers between foreigners and locals. Regression studies have verified that the distance between source and host countries will have an inverse relationship with FDI between the two countries.[396] For example, Resmini found that German investors preferred Hungary and Poland, Austrians preferred the Czech and Slovak Republics, and Scandinavian countries have invested mainly in the Baltic Republics. She takes the point further, arguing that smaller firms are particularly sensitive to cultural distance. This may explain why Italian SMEs, who were among the biggest regional investors at the time, were mainly hosted by Albania, Croatia, Slovenia, Bulgaria and Romania.[397]

The evidence available about the effect of foreign investors' nationality on their attitudes to the law relates mostly to investment in Asia. Perry-Kessaris finds that westerners are more likely than Asians to be sensitive to the Sri Lankan legal climate. For example, firms with no western participation were less likely to have conducted a pre-investment investigation of the Sri Lankan legal climate. Interviewees explained that westerners' sensitivity was due to concerns for repercussions at home, or because of a greater emphasis on the rule of law in western culture.[398] Wang holds that foreign investors who are culturally proximate to China enjoy substantial

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393 Perry 2002, 293.
394 World Bank 2004b, 47.
395 Dunning 1988, 7.
396 For example, Bevan *et al.* 2004, 56.
397 Resmini 2000, 673.
398 Perry 2000b, 793-795.

advantages when investing there.[399] The MIGA study compared the attitudes of Asian, Western European and North American multinational's attitudes to breach of contract and law enforcement, but did not identify any particular trend.[400] In the transition context, the evidence is more sparse, but reiterates the role of culture. For example, Hewko argues that foreign investors from countries with poor legal climates may be more tolerant of imperfections in host legal climates.[401]

4.4 Summary

The literature reviewed above shows that there is a strong reason to believe that attitudes towards host legal climates will vary between investors. Numerous factors were identified, ranging from the size of the firm, to its culture and factors relating to the investment itself. The evidence shows that the Dominant Theory lacks flexibility, as its approach to law and FDI fails to account for how the impact of the law variegates. It is clear that future studies in the field must at least recognise the role of firms attributes, and where possible, assess their role. Hence, the second hypothesis of this thesis is that "foreign investors' perceptions of the Russian legal climate depend on their firm characteristics."

Further, as it is apparent that the challenge posed by a legal climate depends on the perceptions and standpoint of the individual investor, it is impossible to assert that host legal climates need to be of a single standard in order to attract investment. Some commentators believe that instead of an ideal form, (unspecified) minimum standards are required, and others that legal standards will always depend upon what will satisfy a particular investor in a particular case.[402] So, while the Dominant Theory purports to represent all investors, the literature presented here leads one to expect that there this is a significant faction of investors that may not in fact require a Theoretically Ideal Host Legal Climate.

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399 Wang 2000, 542-543.
400 MIGA 2002, 28.
401 Hewko 2002, 5.
402 Michalet 1997, 25 and Pritchard 1999, 1.

5 Conclusions

In Chapter Two it was shown that the Dominant Theory was based on a classical economic approach to the design of investor-friendly legal systems. This gave rise to the concept a Theoretically Ideal Legal Climate, which is considered to be uniformly important and attractive to foreign investors. The present Chapter drew on a range of sources, which included established critiques of law and economics that have generally not been applied to the study of law and foreign investors. The Chapter has aimed to show that certain investors may not conform to the Dominant Theory. It argued that the abstract nature of the Dominant Theory leads to an exaggeration of the importance of a Theoretically Ideal Legal Climate and an oversimplification of the impact of the law.

Hypothesis One is that a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia. The three paragraphs below summarise the three reasons for this hypothesis.

First, the Dominant Theory puts law at the very heart of foreign investment determination. In contrast, the leading theory of FDI determination, the Eclectic Paradigm puts law alongside other determinants of foreign investment. In doing so, the Paradigm shows that the quality of the host legal climate is not a decisive factor. In fact, the attractiveness of a host economy can depend on as many as twenty six factors.

Second, the Dominant Theory also appears to overstate the importance of the law in the way it models the decision to invest. It expects that foreign investors will choose the host on the basis of an 'objective' and 'rational' assessment of detailed information. In fact, perceptions are subjective, and foreign investors may not be able to, nor interested in, acquiring and analysing detailed information about host legal climates before they choose an investment location. Thus, at the time of choosing a host, there is good reason to believe that perceptions of legal climates may be quite superficial.

Third, the Dominant Theory lacks realism in so far as it expects economic actors to avoid legal climates that do not possess Theoretically Ideal attributes. This supposes that there exist no alternatives for securing efficiency and predictability other than by a rule-bound legal climate. In fact, influence, bribery and informal institutions can and do serve investors' purposes in weak legal climates. There was substantial evidence showing that, while foreign investors may proclaim that they prefer a transparent legal climate, they can readily adapt to opaque ones, and so need not shy away from them. In fact, the use of informal institutions and bribery in weak legal climates is consistent with the principles of New Institutional Economics, which as shown in Chapter Two, predicts that economic actors will opt to use these methods where doing so provides greater efficiency and certainty than using the formal legal system.[403]

The Dominant Theory further lacks realism because it does not accommodate differences in the perceptions and attitudes of economic actors towards legal climates. It treats the private sector, let alone foreign investors, as a homogenous group. But the attractiveness of a legal climate is in the eye of the beholder. A range of literature, from the Eclectic Paradigm, to law and development in general and studies on the determinants of FDI, in particular, was surveyed. They all show that characteristics including the investors' size, culture, and factors relating to the investment itself, have an effect on attitudes towards legal risk and the perceived impact of legal climates. Thus, it is very difficult to say that a single legal climate is universally attractive or unattractive, as a legal climate that may be sufficiently predictable and efficient for one investor may be too risky for another. Instead, the heterogeneity of investors must be inherent to our understanding of law and foreign investors. Thus the second hypothesis is that "foreign investors' perceptions of the Russian legal climate depend on their firm characteristics."

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403 See Chapter Two, subsection 1.2.1 and 1.2.2

The Dominant Theory claims that investors "need"[404] the right legal climate, and indeed, when asked, foreign investors do themselves claim to prefer a Theoretically Ideal Legal Climate. However, while ideally they would prefer to operate and invest in such an environment, when faced with non-ideal legal climates, this Chapter has shown that foreign investors can be pragmatic. There is no evidence here, however, as to what proportion of investors do not conform to the Dominant Theory. This would require a well-designed, dedicated piece of research. Nevertheless, it is clear that there is a faction of foreign investors who are less sensitive than expected to the quality of host legal climates.

The pragmatic behaviour of foreign investors is absolutely vital to any appraisal of the Dominant Theory. First of all, its advocates claim that the Theory describes the role of perceptions of the legal climate in the decision to invest, but the evidence contradicts this claim. Second, the evidence shows a discrepancy between the expected behaviour of foreign investors and their actual approach to host legal climates. Further, because a Theoretically Ideal Legal Climate cannot be acquired and installed overnight, the actual of behaviour of foreign investors in the absence of such a legal climate is of relevance to scholarship and policy-making. In short, the behaviour and perceptions of foreign investors show that the Dominant Theory does not accurately portray the relationship between foreign investors and non-ideal legal climates.

It is important to bear in mind that while the evidence that contradicts the Dominant Theory does not form a tidy alternative theory of law and foreign investment, this Chapter has shown that each body of evidence is consistent with well established beliefs and research from related academic fields. At the broadest level, critiques of the abstract assumptions of traditional law and economics are notable as they emphasise the importance of viewing law and economics in a real-world context, rather than on the 'blackboards'. Behavioural law and economics questions the theoretical behaviour of economic actors, and also argues for the importance of the

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404 See Chapter One, subsection 1.2

social context of economic transactions. That field is supported by the work of behavioural decision theory, and the evidence on 'bounded rationality' which demonstrates the limitations in the knowledge, computational capacities and skills of decision makers. Behavioural decision theory assumes that risk is subjectively perceived. Another feature of the management discipline is the work of Geert Hofstede, who in the 1980s showed the impact of national culture on perceptions of risk. All these related fields of study provide credibility and coherence to the findings that contradict the Dominant Theory.

The evidence gathered in this Chapter shows that foreign investors are diverse, may not be well informed about host legal climates, and can be willing to invest in hosts with weak legal climates. This, however, does not entail that advocates of the Dominant Theory are wrong to argue that Theoretically Ideal Legal Climates are best suited to attracting foreign investment. What it does show, however, is that there are a certain faction of 'non-conforming' foreign investors that are significantly less sensitive to the quality of host legal climates than presumed. It also shows that the Dominant Theory is only capable of partly explaining the relationship between foreign investors and host legal climates. Pointing out the limitations of the Dominant Theory is only a starting point. It is more valuable to move on and address the neglected issues to develop a more sophisticated and complete understanding of foreign investors and host legal climates. Chapter Seven explains how this research study went about doing this.

Chapter Five:

Russia's Legal Climate, Past and Present

This Chapter is divided into two Parts. The first analyses key aspects of Russia's legal heritage, starting from the imperial period and leading up to the present day. The second Part focuses in on a range of assessments of Russia's legal climate conducted over the period under study.

Part One: Russia's Legal Heritage

This Part analyses key aspects of Russia's pre-revolutionary, Communist and transition legal environment. The aim is to provide the reader with a sufficient background of Russia's legal inheritance, and in particular, to identify the issues that have influenced the climate and culture that foreign investors encounter today. We start by looking briefly at the rule of law, not as the narrow concept of the Theoretically Ideal Legal Climate which this study is primarily concerned with, but in the broader, political sense.

1 Limiting the Discretion of the Ruler

One of the challenges that has confronted political thinkers throughout history has been the question of how to limit the discretion of rulers, so that citizens are protected from the tyranny and whims of those in power. From the time of the ancient Greeks, the concept of the rule of law has espoused the belief that state authority should be regulated and subject to law, hence the adage the 'rule of law not men.' Aristotle observed that *"he who bids the law rule may be deemed to bid God and Reason alone rule, but he who bids man rule adds an element of the beast; for desire is a wild beast, and passion perverts the minds of rulers, even when they are the best of men."*[405] According to Tamanaha, Aristotle's disinction between the rule of law as reason and the rule of man as passion has endured.[406]

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405 Aristotle cited in Tamanaha 2005, 9

406 Tamanaha 2005, 9

Once one accepts that state authority should be regulated and constrained by rules, the critical question that follows is: according to what principles? At this point we need to distinguish between two traditions found in the west: the rule of law concept that took root in England, France and the USA by the nineteenth century; and the *rechstaat* concept found in Germany in a similar period.

The former rule of law tradition presupposes the existence of certain rights, rooted in human nature and conscience, which the state cannot violate. Within such a system one expects to find a body of stable, widely accepted principles that have primacy over the power of the state. These are typically civil and political rights, such as the right to a fair hearing, equality before the law, and the freedom of speech and association.[407]

In contrast, the *rechstaat* concept holds that the supreme source of law is the lawmaker. Laws only come into being once they are legislated by the lawmaker, and so customs and precedent require codification. More importantly, the rechstaat tradition does not presuppose the existence of any body of fundamental laws external to the state which the state is compelled to abide by.[408] Nevertheless, a rechstaat does require that the state be based on laws, rather than the dictat of the ruler. More importantly, it must be bound by its own laws, which it does not abuse. Hence a rechstaat is a state governed by the rule of *laws*, in the narrow sense of legal rules (*zakon* in Russian) rather the rule of law, in the broader sense which implies justice or right (*pravo* in Russian).

A widely agreed function of the rule of law is to limit the authority and discretion of rulers. This function of the rule of law illuminates our understanding of Russia's legal heritage. While there has been no shortage of liberal and progressive Russian jurists and statesmen, especially in the century prior to the Bolshevik Revolution, as the next section shows, there has historically been a lack of acceptance by Russia's

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407 Berman 1991, 450-151

408 Berman 1991, 451

rulers of an institutionalised authority that might constrain their own. Not only did Russia's rulers reject any body of higher principles (rule of law) which could constrain their discretion, they were also unaccustomed to respecting the laws they themselves promulgated (rechstaat).

2 Legal Thought and Reform In the Russian Empire (1682-1917)

2.1 Peter and Catherine the Great (1682-1796)

Peter the Great (1682-1725) desired to turn Russia into a modern European state and his reforms had a profound effect on Russian law and governance. Peter asserted that the role of the monarch was to labour for the general welfare of his nation, legal justice being a principal component of that. His reforms chiefly took the form of legislation. In fact, Peter's reign marks the turning point in Russian history where written law (*zakon)* starts to take priority over custom.[409] Amongst his reforms of government was the establishment of a Senate; the rationalisation of government departments; and a more meritocratic system of entry into the ranks of the nobility and government posts.[410]

Peter also began the effort to establish legality as the basis of state operations.[411] Using Swedish models, he established the 'Procuracy' which would act as the "eye of the Tsar" checking whether local officials were working in conformity to the law.[412] Indeed, Peter borrowed heavily from foreign models and legislation, even recruiting Europeans into his system until Russians were adequately trained. An area in which Peter borrowed most from western Europe was military and naval law, which underwent codification and appeared in statute form in 1715 and 1720. Though Peter

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409 Butler 2003, 25
410 Feldbrugge 1993, 81-82
411 Feldbrugge 1993, 81-83
412 Butler 2003, 25

appointed three commissions to work on the continuous systemisation of Russian law, none of them progressed far.[413]

The next ruler of Russia to have a significant impact on law and legal reform was Catherine the Great (1762-1796). Catherine was a moderniser who, inspired by Enlightenment thinkers such as Beccaria, Montesquieu and Voltaire, sought to raise Russia to the standards that prevailed in Europe at the time. Her famous "Instructions" (*Nakaz*) contain a framework for political reform. Catherine's Instructions called for a seemingly constitutional form of monarchy. She advocated the seperation of powers between the executive and judiciary. Finally, she also recommended that the judiciary have the power to review laws and to remonstrate to the monarch when the laws may be unworkable, or not conform to the constitution.[414]

The Nakaz, though never enacted, came to symbolise the progressive climate that Catherine was fostering. Under Catherine, instead of being perceived as the "epitome of arbitrariness, Russia was praised in print and public law lectures abroad for having set inspired examples in which other nations might profitably emulate in their law reform undertakings."[415] Despite the progressive tone of her Instructions, Catherine remained a firm believer in the absolute power of the sovereign. She claimed that the very survival of Russia relied upon the vesting of absolute power in a single 'Master.' Further, according to the Instructions, institutions of the state would depend entirely on the monarch for their authority.

Remarkably, the aim of upholding justice translated into a desire to control judges and circumscribe their roles. Both Catherine and Peter were suspicious of the legal profession. Judges were viewed as officials charged with implementing the monarch's law. So that judicial interpretation did not infringe on the sovereign's

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413 Butler 2003, 25

414 Translated in Dukes 1977, 43-121

415 Butler 2003, 28

exclusive privelege as law-maker, the discretion of judges was to be limited as much as possible. Hence, interpretation and precedent were excluded from Russian procedural law as grounds for judicial decisions until as late as 1864.[416]

2.2 The Final Century of the Russian Empire (1801-1917)

While seeking to institutionalise authority over their vast terrains, Russia's emperors could never accept measures that would limit their own absolute power. This approach repeatedly held Russia back from reforms that might have established the rule of law over that of men.[417] This trend can be seen in the stunted reforms of the four tsars who ruled the Russian Empire prior to the Bolshevik Revolution. The first of these is Alexander I.

Alexander I, who ruled from 1801 until 1825, like Catherine the Great, played with the idea of constitutional reform. In 1808 he commissioned a plan for constitutional reform. The project was carried out by Michael Speransky, a pre-eminent reformist minister. Speransky was highly critical of the existing political and social order. His proposals aimed to create a strict seperation of powers between the legislature, judiciary and executive within a monarchical state governed by law. While Alexander was apparently approving of the plan, he eventually shrank from putting it into effect. Instead, a State Council, composed of Crown-appointed officials was instituted. But this leglislative body was not vested with the power to initiate legislation, nor were their decisions binding on the Crown. In short, the State Council did not create an effective limitation on the powers of the Emperor.[418]

The accession of Nicholas I (1825-1855) saw a period of increased codification. Foremost amongst these was a 48 volume chronological collection of Russian legislation from 1649 to 1825. The *Complete Collected Laws of the Russian Empire* is judged to be the most ambitious and comprehensive legal systemisation efforts in

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416 Wortman 1976, 11
417 Wortman 1976, 16
418 Florinsky 1953, 696-698

Europe. Speransky's account of the tome's preperation shows that an adequate record of existing enactments was lacking. The minister recognised that such systemisation was vital to the development of a proper legal system in Russia.[419]

Judicial reform was much discussed during Nicholas's reign. However, it was not until the rule of Nicholas's son, Alexander II, that an overhaul of Russia's court system took place. Alexander II is arguably the greatest moderniser in Russia's imperial history. His 'Great Reforms' started with the emanicaption of the serfs in 1861, but also went as far as decentralisation of government, reform of higher education, the Church and the military, as well as a relaxation of censorship.[420]

Alexander's judicial reforms were a response to the corruption and incompetence of the court system. The reforms were groundbreaking: equality before the law; jury trials; a seperation of the judicial branch from the legislative and administrative branches of the state; and the establishment of a legal profession and bar; as well as a raft of other measures that emulated the established principles of European juriprudence.[421] The post-reform courts were "immeasurably superior" to their predecessors, and the last half century of imperial rule is regarded as the 'Golden Age' of Russian law. The Russian legal profession started to flourish. In fact, during the celebrated political trials of revolutionaries, the Russian courts showed themselves to be remarkably impartial and resilient in the face of a hamhanded state determined to eliminate political opposition.[422]

As one might expect with such far-reaching reforms, implementation of the 1864 judicial reforms proved a challenge. The plans were not applied consistently within the empire. Further, there remained a patchwork of ecclesiastical, military and township courts that held jurisdiction over a wide range of cases. More importantly, in particular at a time of social and political turbulence, the state could not accept a

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419 Butler 2003, 29

420 Freeze 2002, 172-180

421 Florinksy 1953, 903-904

422 Butler 2003, 31; Wortman 1976, 279-283

judiciary that would not be subordinated. The executive eventually reasserted its influence over the courts and the appointment of judges; trial by jury was increasingly precluded; administrative sanction increased; and the openness of trials was limited.[423] The principles of the supremacy of the law, the independence of the courts and individual rights, were irreconcilable with that of autocracy and bureaucratic omnipotence.[424]

The panoply of reforms that Alexander II initiated failed to stabilise a country that was increasingly restive. Alexander was assassinated by revolutionaries in 1881. Upon acceding to the throne, his successor, Alexander III (1881-1894) countered by reaffirming the principles of autocracy in a manifesto. This manifesto was a repudiation of the Great Reforms of his father, and led to the resignation of liberal ministers and marked the beginning of a period of counter-reform.[425] Historians argue that in reasserting the primacy of state power and autocratic leadership, Alexander III's regime oversaw a significant increase in political arbitrariness.[426] Such behaviour fuelled the hatred for autocracy that fanned the fire of civil unrest and revolution.

Alexander III was succeeded in 1894 by Nicholas II (1894-1917), the last of the Russian emperors. At a time when opposotion to absolutism and the pressure for social, political and legal reform was mounting, Russia enthroned a king who from the outset openly declared his hostility to participative government.[427] However, after a decade of his reign, mass strikes, demonstrations and civil unrest – the so-called First Revolution of 1905, forced Nicholas II to issue a manifesto setting Russia on the course for a constitutional monarchy.[428]

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423 Butler 2003, 31
424 Florinksy 1953, 904-905
425 Freeze 2002, 196
426 Freeze 2002, 196
427 Dukes 1998, 176
428 Dukes 1998, 177-178

Nicholas, as a firm believer in the principles of autocracy, could not accept any limitations on his personal power. The eventual 1906 Consititution violated both the spirit and letter of his October Manifesto. Civil liberties, such as free association and speech were restrictively interepreted.[429] Further, a "mistrust of democratic methods permeated the structure of the new legislature". For instance, no law could be passed without the sanction of the Emperor. The Cabinet of Ministers rather than being accountable to the legislature, only reported to the Crown. Further, shortly before the opening of the First Duma, the government issued a set of 'Fundamental Laws' which stated that the Constitution could only be amended on the initative of the Emperor.[430]

The state was intolerant of independent institutions of power. For instance, in 1913, Nicholas sought to amend the Constitution to revert the legislature to a purely consultative body.[431] Nicholas's Interior Minister Stolypin consistently abused provisions of the Fundamental Laws in order to force his will upon the legislature.[432] For example, a loophole in the Constitution allowed him the powerto dissolve the Duma, which he did when it was not compliant.[433] The transition to a constitutional monarchy was bound to be difficult given the climate which prevailed in Russia at the time: high illiteracy; insufficient experience of self-government and formal political organisation; a strong bureaucratic tradition; and widespread unrest and dissatisfaction that had reached a violent pitch.[434]

The political and legal development of the last hundred years of imperial Russia show that the country was developing elements of a democratic tradition, but was lacking, was the institutionalisation of liberal traditions, that is, freedom form the state.[435] In this regard, the underlying political philiosophy of Russia's emperors

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429 Florinsky 1953, 1186
430 Florinsky 1953, 1187-1188
431 Florinsky 1953, 1143
432 Florinsky 1953, 1194 -1195
433 Freeze 2002, 201
434 Florinsky 1953, 1186
435 Freeman 1996, 38

attracts our attention. Historians note that despite extensive reforms, the tsars could never accept that laws, courts or any independent institutions of power should have primacy over their own perogative.[436] Although laws abounded and had been codified, until the 1906 Constitution, Russia's emperors refused to submit to any body of law that could not be subordinated or reversed, and after 1906, the state tried its utmost to undermine such rules.[437] The codification of laws failed in part because of this reluctance on the part of the crown to delegate legislative authority.[438] Hence historians argue that Russia, in contrast to its eastern and western neighbours, lacks a tradition of restraint on the actions of its rulers.[439]

As we have seen, late imperial Russia had planted the seed of what might have become a genuine constitutional monarchy based on the seperation of powers. It is important to point out that some historians argue counterfactually that, had certain events and leading characters been different, Russia's imperial regime may have succeeded in reforming itself peacefully. We can see both liberal and conservative forces at work in her history. Further, it is hard to imagine that, if the country had averted the Revolution of 1917, its rule of law fabric today would not have been far stronger than that which was inherited with the collapse of the Soviet Union. The advent of Communism arrested the course of liberal reform in Russia. Before moving onto the theory and practice of Soviet law, it important to establish that Russia's failure to reform itself effectively was not for lack of liberal and progressive jurists within its borders. In fact, Butler believes that *perestroika* and the quest for the rule of law in the post-Soviet era had their roots in Russia's jurisprudential legacy.[440]

2.3 Russian Legal Thought in the Golden Age

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436 Wortman 1976, 16
437 Freeze 2002, 201
438 Wortman 1976, 16
439 Skidelsky 2004
440 Butler 2003, 78

Historians mark the 'Golden Age' of Russian law, somewhat loosely, from 1850 until 1900.[441] Here a brief survey of some of the leading liberal Russian theorists legal will be attempted. It is evident that liberal forces existed among jurists and the intelligencia. But, it also apparent that the reformists failed to transform Russia into any form of law based state prior to the Bolshevik upheaval of 1917.

There were numerous Russian legal scholars who argued in favour of a law based Russian state. Many were galvanised by their opposition to an autocratic form of government. At the same time, however, their beliefs about the role of law, the state, the use of power and morality differed widely.[442] Boris Chicerin is recognised as the foremost legal scholar of the classical liberal type. For instance, he argued that the aim of the state was to define and defend civil rights and freedoms.[443] Sergei Muromstev contributed to the view of law as independent of the wil of the ruler.[444] Vladimir Solov'ev's approach synthesised the need for individual freedom and rights, with the need for law to establish a basic level of morality.[445]

Up until the final years of the Russian Empire, there remained thinkers who advocated the principles of the rule of law. For example, Sergei Kotliarevskii wrote a major treatise on the rule of law state, in which he argued for the supremacy of *jus* over *lex* and the necessity for popular representation.[446] Pavel Novgorodstev was critical of autocracy, while blaming juridical positivism for the "anti-legalistic" consciousness that pervaded Russia.[447] While an advocate of natural law ideals, Novgorodstev was at the same time wary of the application of Enlightenment models to Russia.[448] Finally, Bogdan Kistiakovskii was also highly critical of autocracy, but also aware of the imperfections in bourgeois parliamentary

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441 Butler 2003, 66
442 Ajani 1992, 9
443 Butler 2003, 63; Ajani 1992, 9
444 Butler 2003, 64
445 Ajani 1992, 10
446 Butler 2003, 67
447 Ajani 1992, 13
448 Butler 2003, 68; Ajani 1992, 14

democracies. He theorised that the ideal model, a socialist rule of law state (*sotsialisticheskoe pravovoe gosudarstvo)* would guarantee the realisation of both human and civil rights.[449]

Historians argue that there was a missing link between what was said in progressive legal theory and political rhetoric, and the actual political reality which prevailed in Russia in the years prior to the Revolution. While Prime Minister Stolypin declared that Russia should become a state based on law rather than on the whim of the ruler, both the Constitution of 1906 and the way that in which he governed were very much contrary to rule of law principles. As noted above, the Constitution neither made provision for the seperation of powers, nor for the supremacy of the law, nor for the liability of ministers and the sovereign. Instead of limiting the discretion of the government and serving as a springboard for a rule of law state, the 1906 Constitution served the political necessity for reversible reforms, and thereby compounded disillusionment with the legal process.[450]

3 Soviet Legal Theory and Practice

3.1 The Response to Capitalism and the Assumptions of Soviet Legal Theory

Marxist-Leninist theory is best understood in contrast to the capitalism from which it reviled. According to Marx, the "means of production of material life condition the social, political and spiritual processes of life in general."[451] Marxist-Leninist theories of the state, society and law can be seen to flow from this axiom.

Marxism-Leninism is highly critical of the bourgeois concept of the law-based state as an independent third party that enforces exchange. Marx and Engels believed that the state, instead of being a neutral mediator, in fact was an "organisation of the class

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449 Butler 2003, 67; Ajani 1992, 14

450 Ajani 1992, 12-13

451 Quoted in Vyshinsky 1948, 322

of the 'haves' to defend itself from the class of the 'have-nots'".[452] Lenin also argued that, as the law and the state are rooted in the economic order, they reflect the will of the dominant capitalist class.[453] Soviet scholars went as far as to argue that the state, as an instrument of force, was the most powerful weapon in the arena of class war. Further, Marx was scornful of the increase in the power of the courts in Europe with, which he associated with the rise of capitalism.[454] Consequently, the rechstaat is written-off as a "mirage" to conceal the rule of the bourgeoisie.[455]

Marx himself did not develop an economic theory of law. The 'commodity exchange theory of law' was articulated in the late 1920's by E.B. Pashukanis. His theory, which actually fell from favour in the 1930's under Stalin, is regarded as the Marxist economic theory of law.[456] According to Pashukanis, all law was based on 'commodity exchange'. For instance, in a capitalist economy, buyers and sellers enter into contracts to define and enforce their reciprocal economic relations.[457] But, in a situation of common ownership and the absence of a free market, buyers and sellers nolonger act freely in their own distinct interest, and therefore do not require a legal relationship. So it was theorised that the need for commercial law would disappear when common ownership replaced private enterprise. Further, in a centrally planned command economy, the role of firms is to fulfill the Plan. Such a role, removing their ability to act freely in their own interest, also will, according to Pashunkanis, "destroy their 'legal personality'".[458] Hence legal nihilism in economic law was, according to Marxist-Leninist doctrine, the natural parallel to the withering away of the state, itself the result of establishing the ideal classless society.

Soviet political theories are also important to our analysis. While Lenin argued that power should be in the hands of the proletariat, he also asserted that the masses were

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452 Vyshinsky 1948, 326
453 Vyshinksy 1948, 329
454 Vyshinksy 1948, 331
455 Pashukanis 1980, 287-289
456 Hendley 1996, 19-20
457 Butler 2003, 71
458 Pashukanis 1980, 279

incapable of acting in their best interests. Instead, Lenin developed the notion that a vanguard party should propel society forward, acting in the best interests of the proleteriat. As a result, the interests of the leadership of the Communist Party came to be presented as those of society at large.[459]

This role was first outlined in Lenin's own writings, and later in the Communist Party programme of 1919.[460] Eventually the Communist Party was anointed in Article 126 of Stalin's 1936 Constitution as the "leading core of all organisations of the working people, in society as well as the state."[461] This role was later given more prominence, by being elevated to the sixth article of in the 1977 Brezhnev Constitution.[462] Commentators argue that the instrumental use of law by the authorities came about partly from the preeminent role bestowed upon the Communist Party. [463] As noted, Marxism-Leninism outrightly rejected, for its association with bourgeoisism, the notion of a law-based state. More practically, the rule of law conflicted with the Leninist political structure, since the former proceeded from the assumption that "law enjoys primacy over the state and restricts it."[464] Hence such a system could not exist alongside the ultimate supremacy of the Communist Party.[465]

Vyshinksy, a jurist whose works articulate the official Soviet line and who enjoyed prominence during Stalin's presidency, provides a brief theoretical justification for the primacy of the state over the law. To Vyshinsky, the idea of the "voluntary self-limitation" of the state is artificial, since the state is the source of all laws. Instead, the binding of state institutions to its own laws is not an expression of the 'self-limitation' of the state's will, but rather the very expression of the will itself.[466]

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459 Hendley 1996, 18-19
460 Feldbrugge 1993, 14
461 Feldbrugee 1993, 99
462 Feldbrugee 1993, 101
463 Hendley 1996, 18
464 Freeman 1996, 50
465 Berman 1996, 449
466 Vyshinsky 1996, 335

Finally, Vyshinksy rejects the notion that the state can be obligated by laws, but counters that the state in fact "*obligates* its subjects."[467]

Legal theory did evolved significantly over the life of the Soviet Union. Developing on Marx's ideas, Pashukanis and his contemporaries believed that the transition to socialism would mark the the death of law and the state. In contrast, the leading Soviet legal theorist of Stalin's rule, Vyshinksy, argued that the state must in fact get stronger, and that law was integral to socialism. However, Stalinist law was associated with extra-legal persecutions and a regime of terror. The Post-Stalinist reaction led to greater procedural and substantive guarantees against state terror, and a revival of interest in the work of Soviet jurists who had been banned under Stalin. In the 1960's and 1970's, there was a more open debate about the definition and meaning of law. Also, the Soviet Union was nolonger conceived as being based on the dictatorship of the proletariat, but was viewed as the state of "all people". This state was expected to "rely less on coercion and more on persuasion", social organisation and democratic processes. The Soviet Union also ratified both the UN Covenants on human rights: International Covenant on Economic, Social and Cultural Rights and the International Covenant on Civil and Political Rights. In fact, these human rights principles penetrated the 1977 USSR Constitution, the fourth and final Constitution of the Soviet Union (the first was in 1918, followed by 1924 and 1936).[468] As subsection 5.2.1 below shows, Soviet legal theory underwent great debate and radical development during the mid to late 1980's, which eventually led to the espousal of the rule of law as the basis for governance.

3.2 Soviet Legal Practise

While legal theory did evolve, what is more important to rule of law analysis is that the core qualities of a rule of law state, such as the legal confinement of state authority, independence of the judiciary, and the procedural regularity of the judicial system are apparently absent from Soviet legal practise. Indeed, the use of law by the

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467 Vyshinsky 1996, 335

468 Butler 1988, 32-40 and 145.

authorities did much to undermine the progress that Russian jurisprudence had made before the Revolution. Here we shall highlight the politicalisation of Soviet law, as well as its procedural and substantive characteristics.

The instrumental use of law by the authorities was a prominent feature of the Soviet legal system. As noted earlier, Soviet ideology rejected constraints on the authority of the state. In fact, Lenin viewed the courts as organs of state power. This political philosophy laid the basis for the instrumentalisation of the law. [469] The new legal institutions were instructed to ignore laws that contravened the spirit of the Revolution. In fact, all references to pre-revolutionary laws were outlawed, though areas untouched by ideology continued to function as before.[470] By defining law in terms of revolutionary justice, law became inherently unstable and liable to abuse. Later, under Stalin, a highly positivistic concept of law as the will of the sovereign, prevailed. Though Stalin's successors did not use law as a vehicle for coercion and terror in the manner that he had, law remained a one-way projection of authority. [471]

The instrumentalisation of the legal sytem included the control of the Soviet courts. After the Revolution, most tsarist judges were fired, while many fled.[472] Judges were heavily dependent upon their political, bureaucratic and judicial masters.[473] Above all, judicial selection and tenure was controlled by the Party.[474] Further, judges were heavily penalised for not achieving performance targets. Judges also lacked financial security, as salaries were low and prized benefits were allocated by local politicians or bureaucrats. The independence of judges was heavily compromised by the fact that a large share of their compensation package depended upon them maintaining good relations, and meeting performance targets.[475]

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469 Hendley 1996, 19-21
470 Feldbrugge 1993, 73
471 Hendley 1996, 19-21
472 Hendley 1996, 22; Ioffe and Maggs 1983, 302
473 Solomon 2001
474 Hendley 1996, 23
475 Solomon 2001

Given the political co-opting of legal institutions,[476] it is argued that Soviet law did not apply equally to citizens. Instead, its application depended on political criteria, such as membership of the Communist Party or connections with its officials. While publicly the Communist Party decreed that interference by its members in invididual cases was not allowed,[477] in reality judges were often instructed how to decide cases by Party officials.[478] In fact, the so-called practise of "telephone law" was openly discussed among jurists and the media during glasnost.[479] Worse, legal institutions were manipulated to give the facade of law to the political persecutions that spanned a quarter of a century. Remarkably, the term "presumption of innocence" was only introduced in Soviet legislation at the very end of its life, in 1990.[480] After Stalin's death, Khruschev reformed the courts to ensure that the purges could not happen again. While the risk of government terror subsided after Stalin, both in theory and practise, the legal system remained an instrument to further the goals of the regime.[481] As a result, ordinary citizens viewed law as something to be avoided rather than relied upon.[482]

When cases did not have a political dimension , even in Stalin's reign, the courts operated normally. But there were no clear lines between political and non-political cases, and so the "specter of interference always hung over a trial." More importantly, while the Party did not take an interest in most cases, the willingness of the courts to submit to political authority undermined the credibility of the legal system and public trust. Hence the Soviet system exhibited a "dual legal culture" in which procedural regularity was not always absent, but lacking often enough that it could not be relied upon.[483]

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476 Aron 2002, Krasnov 2002.
477 Butler 1988, 172
478 Hendley 1996, 22
479 Freeman 1996, 40-41
480 Butler 1996, 15
481 Hendley 1996, 22-24
482 Hendley 2004, 608.
483 Hendley 1996, 25

Hendley examines the characteristics of Soviet laws and law-making. While the statute books themselves were quite stable, legislation was frequently amended by administrative regulations that went unpublished, contributing to the inaccessibility and instability of laws. The law also lacked coherence as rules were issued in response to discrete problems, with the jurisdiction of departments often overlapping. Further, laws were often changed to suit the requirements of the powerful. In fact, judges often had to reason backwards to add the 'colour of law' to the outcomes demanded from them. Finally, the Bolshevik mistrust of written law resulted in laws that were often deliberately vague.[484]

4 Perestroika & Transition

The legal developments of perestroika and transition occurred on the surface of the demise of the Soviet Union and a radical change in Russia's political-economy. Thus, before addressing the legal developments, it is necessary to provide an overview of the political-economy of the period.

4.1 Economic Reforms under Gorbachev, Yeltsin and Putin

By the 1980's, the Soviet Union was in clear economic decline, suffering from wide a range of problems, such as: low investment returns, inefficiency, poor management, and shortages in a wide range of consumer provisions.[485] Gorbachev's response was tempered, apparently believing that while in need of reform, the core elements of the Soviet system, such as central planning and the leadership of the Communist Party, could be maintained. One of his first economic policies was an anti-alcohol campaign, designed to improve economic efficiency and reduce social expenditures. In 1986, private economic activity was permitted in the strictly limited form of small family businesses. In 1989, the Law on Leasing decentralised the economy to a certain extent, by increasing the rights of leaseholders. Gorbachev also recognised the importance of price reform. However, such a move was anticipated to provoke

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484 Hendley 1996, 25-29

485 Sakwa 1991, 268

inflation and was therefore too politically challenging.[486] By the end of the 1980's, it was becoming clear that piecemeal changes were inadequate, and that the Soviet Union had to implement more fundamental reforms.

The radical economic reforms needed to 'marketise' the Soviet economy occurred from 1991 onwards, under Yeltsin's leadership. The task of transforming the Soviet economy into a capitalist market economy rested on three main policy pillars: the liberalisation of prices; strict monetary and fiscal policy; and rapid privatisation. These radical reforms were undertaken in very quick succession from late 1991. Shock therapy, as these reforms collectively came to be called, were based on the IMF's advice and were often a condition placed by the Washington institution on its loans. Unfortunately, Russian GDP fell dramatically, by around 54% between 1990-1999; there was massive currency flight; and dramatic increase in the share of Russians living in poverty (2% in 1989, 23.8% in 1998). In August 1998, heavily indebted, the Russian government defaulted on its international debts and devalued the rouble.[487]

Putin succeeded Yelstin in 2000, and his presidency has benefited greatly from the steady increase in the price of oil. Around 20% of the state's revenues come from oil exports, and so according to one calculation, every $1 increase in the oil price garners the $1 billion in income. This income has massively improved the country's fiscal position, and provided with foreign currency surpluses, allowing the government to repay its vast foreign debts. Under Putin, Russia came to fully accept capitalism, and moved on to the next round of reforms. These reforms have concentrated on improving the investment climate, for example by reducing the burden of taxation and regulation, improving the legal system, and strengthening corporate governance.[488]

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486 Sakwa 1991, 274-280
487 Stiglitz 2002, 142-153
488 Sakwa 2004, 183-191

4.2 Legal System

4.2.1 Developments in Legal Thought During Perestroika

The ambition of establishing a 'socialist law-based state' (*sotsialisticheskoe pravovoe gosudarstvo*), was according to Butler, the most significant policy of perestroika. In fact, he argues that the success of all the other political and economic reforms rested on this policy.[489] The term 'pravovoe gosudarstvo' was actually banned during much of the Soviet era for its association with bourgeois thought.[490] Political discussion of the rule of law did occassionally occur in the Soviet Union after Stalin, and the issue was even debated at the 1976 Communist Party Congress. However, it was only after the free debate or *glasnost* which Gorbachev encouraged that those within the Soviet Union were ably to publicly criticise the corruption, injustices and political subversion of the legal system without fear. This debate, among journalists, academics, politicians and legal professionals, developed into a movement for legal reform.[491] For the first time since the Revolution, Soviet jurists started to associate themselves with the tradition of legal and political thought that went back to Locke, Kant and even Plato and Aristotle.[492] The debate was groundbreaking as it presupposed the introduction of genuine democratic principles. By 1988, a law-based state emerged as fundamental new dimension in Soviet political thought and a central tenet of perestroika.[493]

This period marked the most significant development in Soviet legal theory: the acknowledgement that law in the narrow sense of rules (*zakon*) is distinct from law in the broader sense of justice and right (*pravo*). Legal rules, as the Soviet experience showed, are forever subject to the whims of the legislator, while the broader concept was notable as it held out the promise that the Soviet Union might come to embrace universal human values. Indeed, human rights principles and the rule of law were

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489 Butler 1996, 10
490 Barry 1992, xiii
491 Solomon 1990, 16
492 Berman 1991, 449
493 Berman 1991, 449

set out in the 1990 Draft Constitution of the Russian Federation, and were eventually enshrined in the 1993 Constitution. The very first Article of the Russian Constitution declares the country to be a rule of law state, while the most extensive chapter of the Constitution enumerates the rights and freedoms of man.[494]

4.2.2 The Judiciary: Reform and Present Structure

Gorbachev was well aware of the need for legal reform. The Soviet courts were a priority, as their quality, professionalism and independence were all in question. In 1989, legislation was enacted to increase the salaries and tenures of judges. The new law also attempted to protect judges from interference and provide redress against unlawful actions by public officials. In 1991, the Constitutional Court was established, finally elevating the judiciary, at least formally, to a branch of government equivalent to the executive and legislature.[495] The following year, in an important step for judicial independence, judges were granted life tenure. The power and jurisdiction of the courts was also expanded during this period.[496]

Russia's present judicial structure was established by the 1993 Constitution (Articles 118-129), in conjunction with the Federal Constitutional Law of the following year. Russia's Constitutional Court is composed of 19 judges. The Constitution grants it a broad jurisdiction, for example: it may examine the conformity to the Constitution of federal and regional laws and treaties; it also determines disputes concerning competence between State agencies; the Constitutional Court also considers appeals against violations of the constitutional rights of citizens, as well as the constitutionality of laws being applied.[497]

The *arbitrazh* courts, which in the Soviet era arbitrated and adjudicated disputes between state enterprises, today deal with economic cases. Headed by the Supreme

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494 Butler 2003, 705-715
495 Butler 1996, 423
496 Solomon 2001
497 Butler 2003, 154-155 and 730-731

Arbitrazh Court, the courts are regulated by the 1995 Law on Arbitrazh Courts and 2002 Code on Arbitrazh Procedure. Their jurisdiction encompasses economic disputes involving foreign firms and foreign investors. In 2001, the courts received 745,626 petitions to sue; remarkably, half of these were in the domain of administrative disputes, such as taxation, or cases to declare the acts of state agencies invalid.[498]

The courts of general jurisdiction which deal with civil and criminal cases have a separate system of trial, appellate and Supreme Court process. Article 126 of the Russian Constitution establishes the Supreme Court as the highest judicial body for civil, criminal and administrative cases. The judicial system is administered by the Ministry of Justice, which has an important range of responsibilities, such as the drafting of the courts' operating procedures, the training of its personnel, and the harmonisation of laws across Russia's numerous republics, regions, territories, municipalities and other jurisdictions. The procuracy form another important element of the Russian judicial system. The procuracy was first established by Peter the Great in 1702, sidelined in the 1864 reforms, and revived under Lenin in 1922.[499] The institution is responsible for ensuring the implementation of statutes by the various government ministries and agencies.

Believing that the economic development of Russia and the attraction of investment required a competent and reputable judicial system, President Putin has taken a strong interest in the judiciary. The judiciary had suffered from a perception of widespread corruption which did not reflect the improvements that had occurred in the post-Soviet period.[500] Under his leadership, Russia's far reaching judicial reform has gained momentum. One example is in the financial support of the courts. Article 124 of the Constitution determines that the courts should be financed exclusively

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498 Butler 2003, 166-169

499 Sakwa 2002, 74

500 Solomon 2002, 119.

from the federal budget,[501] but in practise, the courts have relied heavily on supplementary payments and allocations provided by local or regional governments.[502] In the first years of his presidency, Putin increased the federal budget for the courts significantly. This move was coupled with the removal of regional governors from the process of appointing and promoting judges, making the courts more independent of local politicians and businessmen.[503] Putin also adopted new procedural codes for the civil, criminal and arbitrazh courts, and made efforts towards the harmonisation of laws across Russia.[504]

At the same time, however, there have also been some significant impetuses towards counter-reform under Putin which, if realised, would have undermined the fundamental principles of judicial independence. First, there were proposals authored by the Minister for Economic Development to replace the life tenure of judges with non-renewable 15 year terms. Second, in late 2002, a Parliamentary Committee approved proposals to make the decisions of the Constitutional Court non-binding on regional governments, thereby reducing the Court to an advisory body. The final significant assault on judicial independence came in the form of the proposals authored by Seregi Mironov, speaker of the Federation Council, the upper house of the Russian Parliament. In September 2004, his draft law was approved almost unanimously by the Federation Council. The proposals aimed at significantly increasing the influence and discretion of the President in the Judicial Qualification Collegia, the body responsible for the appointment, promotion and discipling of judges. The opposition of jurists prevented the plans from coming into action.[505]

4.2.3 Legislative Developments

In this subsection we will address some of the essential legislative developments that have taken place over perestroika and transition. The reader should keep in mind

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501 Butler 2003, 730
502 Solomon 2004, 573
503 Solomon 2002, 122.
504 Solomon 2004, 550
505 Solomon 2005, 7-15

that it is widely felt that there is a sizeable gap between the law on the books and the law in practise in Russia.[506] The perceptions and actual experience of foreign investors is examined in the next Part, as well as, of course, in the fieldwork.

The transition to a market economy required the enactment of a panalopy of laws and the establishment of a range of institutions. The foundation of Russia's market economy, or the so-called 'constitution of the economy' is the Civil Code. The Code was enacted and came into force in three parts, Part One in 1994-1995, Part Two in 1995-1996, and Part Three in 2001-2002. Part IV, on intellectual property rights, has been drafted and is being debated.[507] The Civil Code draws on Russia's pre-revolutionary civil law tradition, as well as continental civil law, Anglo-American law and Soviet laws.[508]

The Civil Code covers, *inter alia*: contracting, purchasing, leasing, banking, insurance, and intellectual property. The Code is wide-ranging but not comprehensive, and instead provides for the enactment of federal laws on particular matters. Here we shall demonstrate the operation of this principle in three areas of commercial law: incorporation, bankcruptcy and taxation. The Code regulates, in conjunction with Law on Joint-Stock Societies, the incorporation of joint-stock companies, the most common organizational-legal form of business in Russia. Bankcruptcy is not regulated by Code, but by separate federal legislation. Since 1992, there have also been a series of bankcruptcy laws in Russia: in 1992, 1997, 1998, and most recently, the 2002 Law on Bankcruptcy.[509] Russia's present taxation system is similarly the product of a series of legislation spanning a decade. Investors can be forgiven for feeling that tax system in Russia lacks stability, as the 2002 reforms contained 200

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506 See Chapter Five, subsection 8.2, and Chapter Six, subsection 3.1

507 See the internet site of the Coalition for Intellectual Property Rights, under 'Advocacy', 'Civil Code'.

508 Butler 2003, 358-397

509 Butler 2003, 445-448

amendments, including a celebrated reduction in corporate profit tax from 35% to 24%.[510]

Legislative development in transitional Russia has been assisted by the World Bank and EBRD, although the actual impact of their lending and advice is not well documented. One of the aims of the World Bank's involvement in legal reform projects in Russia has been to improve the performance of the legal system in areas necessary for the proper functioning of market institutions. Part of a $58m loan in 1996 was spent on establishing a Russian centre for coordinating legislative drafting, called the Commission on Legal Drafting Initiatives.[511] The EBRD's role has been more particular. The EBRD helped in training officials in the implementation of capital market regulations. The organisation also held seminars with Russian parliamentarians to explain amendments to company and securities legislation.[512]

There have been a number of legal and administrative reforms that have affected foreign investment since President Putin took office in 2000. Above all, there has been a strong push towards centralisation of government. Although there were political reasons for this policy, as far as foreign investors are concerned, the move should help to reduce regional variability in Russia, and reign in regional governments, all of which can help to make the business environment more transparent and predictable. This strategy was implemented via the harmonisation of laws, the reduction in discretion allowed to the regions in tax policy and administration, and also the creation of seven federal districts or 'super-regions', each monitored by a plenipotentiary appointed by and reporting to the President.[513]

Four other administrative reforms have improved the investment environment in Russia. The foremost is the new Tax Code. Prior to the reforms, possibly foreign investors' biggest complaint about Russia was the country's tax laws. There were a

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510 Sakwa 2004, 187
511 World Bank 2003, 31-32
512 EBRD 2002a, 8-11
513 OECD 2006, 42-43

multiplicity of different taxes, as well as a bias inherent to the tax structure which discouraged business activity, and thereby forced firms to do evade taxes. The new Tax Code, which was came into force in two parts, first in 1999 and then 2001, contained many welcome changes relating to VAT, excise, social taxes, personal income tax and corporate profit tax. Further reforms aimed at harmonising the tax system, reducing tax rates, and limiting the discretion of administrative agencies have also taken place since.[514] Other reforms that have affected the business environment include improvements in shareholders' rights, a new customs code, and new foreign exchange laws, which bring Russia in line with international practise.[515]

5 Foreign Investment Laws and Policies

5.1 Perestroika and the Yelstin Presidency

Interestingly, the cycle of economic reform in the Soviet Union actually started with foreign economic relations.[516] Foreign investment was encouraged by Soviet reformers as it was viewed as a catalyst for the domestic economy. The move was part of a broader acceptance, as witnessed in the 12th Five-Year Plan (1986-1990), that the Soviet Union should aim for greater involvement in the world economy. Joint ventures were first made possible by three decrees spanning mid 1986 to early 1987. Initially, the legislation governing the operation of JVs was quite restrictive, but was latter relaxed, leading to an increase in registrations.[517] According to one source, by July 1990, 1830 joint ventures were signed,[518] and by 1991, this figure had risen to over to 3000.[519] Joint ventures were seen by Soviet policy-makers as way of transferring western technology, skills and management practices, and producing goods and services that were not adequately produced domestically.[520] Western partners in joint ventures were not subject to Soviet planning instructions, nor were

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514 OECD 2004, 32-35.
515 OECD 2004, 14. For a comprehensive review, see OECD 2004, Chapter Three.
516 Butler 1996, 424
517 Geron 1990, 43
518 Geron 1990, 39
519 Butler 1996, 14-15
520 Geron 1990, 40

they guaranteed purchases and sales. Thus the introduction of JVs symbolised the decentralisation of the Soviet economy, a major departure from past policy.[521]

Between 1990 and 1991, a quick succession of laws enabled foreign juridical and natural persons to actually fully own, or invest in, Soviet legal entities. A Presidential Decree in 1990 was followed by the Principles of Foreign Investment Legislation in July 1991, and eventually the Russian Foreign Investment Laws of October 1991.[522] An overview of investment policies under President Yeltsin will be presented before we examine current legislation.

The Government Decrees of the mid-1990's present a glimpse of the foreign investment policy activity of the Yeltsin goverment. The "Decree of Government of the Russian Federation on Activization of Work Relating to the Attracting of Foreign Investments to the Economy of the Russian Federation", adopted first in September 1994, and subsequently amended several times until November 1999, appears to be the blueprint for Russia's transition foreign investment policy. The Decree instructs numerous federal ministries and agencies to submit policy proposals within two to three months, and within the scope of their competencies aimed at promoting foreign investment. The Ministry the Economy was to lead foreign investment policy, working in conjunction with, *inter alia*, the Ministries of Foreign Economic Relations, Finance, Foreign Affairs, Justice, Construction, as well as the State Committees of Industrial Policy, Defence, Administration of State Property, Customs, Anti-Monopoly, and the Central Bank and other federal institutions.[523]

The range of government bodies and the scope of activity mandated by the document show that the Yelstin administration felt that much needed to be done to create the conditions for the attraction of foreign investment. Above all, the Decree instructs the various ministries and committees to submit amendments to Russia's

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521 Geron 1990, 42-43
522 Feldbrugge 1993, 274
523 Butler 2002, 710-715

main foreign investment legislation. Also required was a list of activities and territories where foreign investment would be restricted. The Government of the day was also concerned about the provision of information for foreign investors on relevant legislation, programmes and projects. Interestingly, further areas of activity mandated by the Decree include improvements in the system of registration of firms and statistical reporting.[524]

One other Government Decree, issued in January 1995, is of interest. This Decree establishes a "Centre for the Promoting of Foreign Investments". The Decree amounts to a charter for the Centre. The principal tasks of the Centre involve providing information and assistance to foreign investors, as well as "improving the image of Russia as a country accepting investments" and other marketing tasks.[525]

The government texts cited on foreign investment policy have been translated by Professor Butler, however, he does not provide any commentary on them. Similarly, this author has not been able to find any information on the realisation and effectiveness of these initiatives, nor on the activities of any of the government bodies, including the Foreign Investment Promotion Centre. In any case, the foreign investment policies of the Yeltsin administration are not our immediate concern.

5.2 Present Foreign Investment Laws and Policies

5.2.1 The Law on Foreign Investments

After the dissolution of the Soviet Union in late December 1991, there was a swift succession of legislation relating to foreign investment. The aforemention 1991 Russian Foreign Investment Laws was amended four times: in 1995, 1999 and 2000 and 2003. However, it is a separate 1999 Law on Foreign Investments, itself amended

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524 Butler 2002, 710-715

525 Butler 2002, 716-717

in 2002, 2003, 2005, and 2006 that is considered most important in the eyes of investors.[526]

The 1999 Law defines who may be a foreign investor. Foreign firms, citizens, states and international organisations are all permitted to invest in Russia. Under the 1991 Law on Investment Activity foreign investments are defined in the same way as investments generally. The 1991 Law offers an economic definition of investment.[527] The 1999 Law on Foreign Investments provides a more specific definition: "the investing of foreign capital in an objecct of entrepreneurial activity on the territory of the Russia Federation in the form of objects of civil rights which belong to the foreign investor..."[528]

Writing in 2003, Butler argues that every foreign investor in Russia has, "somewhere in its subconsciousness the apprehension" that political powers seeking to renationalise state property may prevail, or that the state or its subjects may attempt to deprive foreign investors of ownership over their property.[529] Thus, it is significant that the 1999 Law provides, at least in principle, a string of guarantees to foreign investors. There are ten guarantees, including: guarantee of compensation in the event of expropriation or renationalisation; guarantee to the use of revenues and profits, including transfer abroad; and the guarantee to participate in privatisation.[530] The 1999 law also stipulates national treatment for foreign investment.[531]

5.2.2 International Agreements and Bilateral Investment Treaties

Russia is also party to a number of international agreements that govern or affect foreign investment. Russia ratified the 1958 New York Convention on the Recognition and Enforcement of Foreign Tribunal Awards in 1960. The

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526 Butler 2003, 631
527 Butler 2003, 633
528 Butler 2003, 633
529 Butler 2003, 634
530 Butler 2003, 637
531 OECD 2004, 12

implementation of the treaty since the 1990's has been controversial. Consistent with Butler's assertion about foreign investors' fears, the Russian courts are perceived as being overly willing to interpret and apply the narrow grounds upon which foreign tribunal awards may be legitimately refused recognition or enforcement. The absence of published judicial decisions, however, makes an accurate assessment difficult. The country has signed the Energy Charter Treaty, which it has yet to ratify. The Treaty is a legal framework that seeks to regulate investment, trade and transport of energy resources.[532] Finally, the country is also party to the 1950 European Convention on Human Rights which can affect foreign investor's rights via Article 6, on the right to a fair trial. In fact, a number of cases relating to the Yukos affair, described below, are due to be held in the Strasbourg court.[533]

A further important aspect of the Russia's foreign investment regime are the country's Bilateral Investment Treaties (BITS). By the end of 2004, Russia had 35 BITS in force, with a further 17 awaiting ratification. According to the OECD, Russia lags behind international good practise in the BITS. For instance, recent trends in BITS include provisions regarding: the entry of key personnel, the transparency of laws and proceedings and third party participation in dispute resolution. These provisions can be found in a small number of Russia's BITS, but not in its Model BITS.[534]

5.2.3 Formal Restrictions

While most formal restrictions on foreign investment have been lifted, many are still in force. Foreign investment in the following sensitive sectors can be subject to restrictions: aerospace, agriculture, aviation, banking, defence, insurance, natural gas, electric power, mass media and natural resources. Restrictions typically take the form of a limitation on the share of capital a foreign investor is permitted to hold, although in some cases, such as land acquisition and construction projects, the

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532 OECD 2004, 94

533 OECD 2006, 76-77

534 OECD 2006, 60; more a comprehensive survey, see OECD 2004, Chapter 5.

Russian state reserves the right to block any investment.[535] There is no research, to the author's knowledge, about the impact of these laws and whether they constitute effective barriers to investment, or whether loopholes in these laws exist, or whether senior government officials can intervene to permit foreign investment in certain cases. This would make an interesting case study.

There have been recent moves towards making foreign investment restrictions more transparent. A new law, due to be submitted to the Russian Duma by the end of 2006, is being drafted which will attempt to unify the restrictions within a single piece of legislation. The law aims to establish the principles around which foreign investment can be restricted, by addressing three questions: which sectors should be restricted? What form of control should be imposed? Who should implement the controls? Subsoil laws governing investment in natural resources are also being discussed.[536]

There is another way in which the legal climate might act as an absolute barrier to investment. It is arguable that the absence of a particular body of commercial legislation, such as intellectual property law, may render investment in Russia very difficult or impossible. However, a recent survey of intellectual property owners has shown that they are most concerned with the enforcement of existing legislation, and would like the Russian government to concentrate their efforts on enforcement rather than the drafting of new legislation. Further, of eighty firms surveyed, only 4% had cancelled or reduced new investments in Russia due to concerns about inadequate IP rights protection or enforcement.[537] In any case, this research study, does not focus on the impact of absolute legal barriers to foreign investment or specific bodies of legislation.

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535 Hogan & Hartson LLP 2006

536 OECD 2006, 56-57

537 The Coalition for Intellectual Property Rights, 2006

5.2.4 Foreign Investor's Perspective

Keeping in mind the extent of change that Russia has under gone in the last fifteen or so years, and the shortcomings of the country's judiciary and bureaucracy, it is unreasonable to expect that legislative and administrative reforms will take effect fully in the short term. For this reason, it is important to continue to assess foreign investors' perceptions of the investment environment. Here we shall review a 2005 OECD survey of 102 foreign investors which examines their perceptions of foreign investment policy.

The survey found that 64% of respondents believed that Russian government policy for attracting foreign investment was "insufficient and ineffective", although a similar proportion, 70%, were satisfied with the availability of relevant regulatory information. What may explain this divergence is the poor quality of the general regulatory environment. Firms complained most about visa information, land registration, and environmental regulations, especially in the regions. Further, foreign investors while generally satisfied with the role of federal authorities in implementing investment policy where dissatisfied with regional, local and lower levels of government in the same capacity.[538]

6 The Role of the State in the Economy

6.1 Introduction

As Professor Butler pointed out, in Russia, the political climate and the role of the state in the economy have a clear impact on the perceived security of foreign investors' rights. At this point we therefore turn away from the formal legislative developments and nominal reforms that have taken place, and try to present a fuller and more realistic picture of how the legal system actually functions in Russia, rather than how it is supposed to. In order to do this, a brief introduction into the law and

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538 OECD 2006, 26-27

politics of transition is required. Part One of this Chapter closes with an analysis of recent key events in the legal and business world in Russia.

It is said that countries in transition face the tension between the need for a strong state to enforce law and order, and the need for constraints on state power.[539] While a weak state gives rise to the "unrule" of law, a strong state can be even worse if the state is manipulated by narrow vested interests.[540] According to political commentators, for a Theoretically Ideal Legal Climate to emerge, the enhanced law enforcing capacity of the state must be coupled with 'autonomy': policy formation must be independent, and not hijacked by special interests.[541]

The state that President Putin inherited was lacking in both authority and autonomy. Yeltsin's presidency was marked by a deterioration in state capacity, an increase in corruption, tax evasion, and lawlessness generally.[542] The Yelstin presidency witnessed the archetype of state capture: the sale of hugely valuable national assets, especially natural resource firms, to well-connected 'oligarchs' at undervalued prices. Once these Yeltsin supporters had funded his re-election, they exercised enormous influence over the state,[543] emerging as major corrupters of the government, and undermining reform efforts.[544] Many felt that the Russian state was close to collapse by the time Yelstin resigned in 1999.[545]

Enhancing the capacity of the state and lawfulness was therefore an inevitable policy goal for President Putin.[546] Putin famously announced that establishing the "dictatorship of law" would be the core of his first term in office.[547] To this end, in 2001, a series of judicial reforms were enacted that aimed to improve the reputation of the courts. Judicial reform was considered critical by policy makers for attracting

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539 World Development Report 1996, 88.
540 Gel'man 2004, 1025.
541 Taylor 2003, 1.
542 Berglof *et al.* 2003, 45-56.
543 Black & Tarassova 2002, p.16.
544 Black & Tarassova 2002.
545 Hanson & Teague 2005, 662.
546 Tompson 2005, 1.
547 Aron 2004, 3.

investors.[548] Among the Russian public, there continues to be a widespread desire for a strong state and law and order. For example, in the run-up to the 2004 presidential elections, a nationwide poll found that the second most important domestic priority that respondents expected from their president of choice was "the strengthening of law and order". Part of President Putin's popularity is owed to his association with a stronger state.[549]

President Putin's main priority upon acceding to the Presidency was to strengthen the Presidential Administration and the central state. One of the ways in which he achieved this was by curbing the power of the oligarchs who, it was widely felt, had 'captured' the Russian state. In July 2000, he held a meeting with 21 of Russia's tycoons. In the meeting, which "soon acquired the status of something like a foundational political myth" President Putin laid out the basis for business-state relations: he promised, it is alleged, that the illegitimate privatisations in which the tycoons had made their fortunes would not be revisited, on the condition that the businessmen refrained from politics.[550] The political imprudence of two erstwhile media magnates and Putin propagandists, Boris Berezovsky and Vladimir Gusinsky, led to their exile; their media empires were transferred to the state.[551]

The feature of Putin's recent policies and the Russian legal environment today that draws our attention is the role of the state in the economy. The involvement of the state and government officials in business life, from the Kremlin down to regional governors and local bureaucrats, is arguably the distinguishing feature of the Russian investment climate. In the subsections that follow we shall analyse, first, the *Yukos* affair, which is the most symbolic and notorious example of the state's involvement in the private sector, and second, the institutional features that have fostered the nature of this relationship.

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548 Solomon 2002, 119.
549 Aron 2004, 3.
550 Tompson 2005a, 1; Tompson 2005b, 168.
551 The Economist 2003.

6.2 The Yukos Affair

Over the course of 2003-2004, the oil firm Yukos was issued with retrospective tax claims and penalties amounting to over £12 billion.[552] By freezing the company's bank accounts and setting impossible deadlines, the courts ensured that the company was unable to pay its tax bill. These claims led Russia's most successful firm to the verge of bankruptcy and the forced auction of its most valuable asset, a major oil production unit. The unit, *Yuganskneftegaz*, was sold in a government auction to an unknown financial group, called the *Baikal Financial Group*, which was apparently registered at a provincial grocery shop! Matters became clearer as Baikal was immediately taken over by *Rosneft*, the state owned oil producer. In this way, the state became the owner of the most prized asset in the Russia oil industry.[553]

The manner of the demise of the country's largest oil firm symbolises why the role of the state in the Russian economy might unsettle foreign investors. For a start, the very campaign against the firm and its owners is widely attributed to the Kremlin, rather than the tax authorities. The prevailing view – endorsed by the Parliamentary Assembly of the European Council, no less - is that the assault on Yukos was a calculated plan by the Kremlin to eliminate political opposition from the oligarch-founder of Yukos,[554] and to strengthen the state's control over its natural resources, which are central to the country's economic development and foreign policy. [555] This view is given credence by the fact that, at the same time as the Yukos prosecution, a parallel campaign was waged against Yukos' founder, Mikhail Khodorkovsky, who was tried and convicted (in June 2005) on various counts of fraud and tax evasion. Mr.Khodorkovsky stands out from the rest of the oligarchs, who have not been prosecuted for similar crimes, in so far as he was considered to be becoming too powerful and politically ambitious. So, his 'real crime' is that he funded various

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552 The Financial Times 2004a.

553 The Financial Times 2004c.

554 The company's founder, Mikhail Khodorkovsky, was sentenced in June 2005 in a Moscow court on numerous charges such as tax evasion, fraud and corruption.

555 Council of Europe 2005.

opposition parties in the Russian Duma to Putin's *United Russia*, forged relations with US oil firms and politicians, and used his position to sway energy policy.[556]

To add to the suspicion, the chairman of Rosneft, the firm that has benefited most from Yukos' collapse, is a close ally of the President and a deputy head of his administration.[557] Further, Yukos' lawyers and the Council of Europe both allege that there were numerous abuses of legal and administrative processes in the two cases, hence contravening rule of law principles and even violating Russia's human rights commitments![558] A senior economic advisor to President Putin broke ranks and openly called the affair the "swindle of the year."[559]

The involvement of the highest authorities in Yukos as well as other big businesses in Russia during 2004 created a damaging level of uncertaininty. For example, a marked increase in capital flight and the downward revision of investment and growth forecasts were blamed by economists on the assault on Yukos.[560] Another tax claim that was also suspected to be politically motivated,[561] against *VimpelCom*, Russia's second biggest mobile communications provider, resulted in a 10% drop in the value of the entire Russian stock exchange over two days. The tax claim heightened fears among investors of increasing political interference in business. Commenting on the climate at the time, a former economics minister remarked that "as long as the situation in the country depends on the mood of the president or his colleagues in the Kremlin, business has no reason to trust the future."[562]

6.3 The Institutional Setting

The 'mutual penetration' of the state and private sector in Russia is great, even when compared historically to countries such as Japan or Italy.[563] Moreover, it occurs at

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556 Economist 2005.
557 The Financial Times 2005.
558 See Council of Europe 2005, and Amsterdam & Peroff 2004.
559 The Economist 2005.
560 The Wall Street Journal 2004.
561 The Moscow Times 2004a, The Financial Times 2004a.
562 The Washington Post 2005.
563 Hanson & Teague 2005.

every level of government and business, from multinationals such as Yukos down to small businesses.[564] We are prompted to inquire: what is it about Russia's institutional environment that causes such an unusual interdependence between business and the state? This issue is so salient to the Russian business environment that interest in it is no longer confined to the business press, but has recently provoked scholarly interest too.

Tomspon characterises the relationship between the state and business as "mutual penetration." During Yelstin's presidency, the oligarchs 'captured' the state by cultivating relationships with key officials and securing the appointment of their representatives into posts at every level of government. Smaller businesses too had to maintain cordial relations with government officials. In reality, the relationship is one of mutual exploitation. In the words of German Gref, the Minister who has been the architect of Russia's economic reforms "there remain a mass of administrative barriers and a rather wide field for officials to make subjective decisions. As a result, there is the wish of officials to participate in the unlawful redistribution of company profits."[565] This discretion enables bureaucrats to intervene at all regulatory levels, from the granting of natural resource and telecommunications licenses that can be worth hundreds of millions of dollars, to everyday fire and health inspections, "which can shut down small businesses on the flimsiest of excuses."[566] Naturally, this provides bureaucrats with power over the private sector plus a source of additional income, and in turn, businesses with an incentive to capture the state, bribe its officials, or at least cultivate friendly ties with them.

Indeed, foreign investors use their connections to resolve legal, regulatory and tax problems. For example, the Swedish retailer IKEA, which is one of the highest profile foreign investors in Russia, appealed to the Minister for Trade and Development as well as to the governor of the Moscow region when the opening of its £150 million

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564 Tompson 2005b, 166-167

565 The Moscow Times 2004i.

566 Tomspon 2005b, 166-167

'mega-mall' was delayed by Moscow bureaucrats.[567] The chairman of Russia's biggest foreign investor BP met with President Putin shortly after two unsettling developments for the firm: the first, a £500m tax claim on the firm's local subsidiary, and the second, new subsoil laws that aim to restrict firms with majority foreign ownership from participating in bids for strategic oil and gas fields.[568]

At a general level, the state is the stronger party in this relationship, because it holds both the metaphorical carrots and sticks. According to Tompson and Ledeneva, everyone in Russia is under the threat of punishment. The reason for this lies in the characteristics of the institutional climate. State institutions tend to be opaque, and their officials arbitrary. This is exacerbated by the inconsistency and complexity of laws, which is a double-edged sword: it not only invites arbitrary action, but makes it difficult to know how to abide by the law. The regulatory, legal and taxation climate creates a situation, it is argued, that makes it impossible to do business in Russia without breaking the law.[569] Reviews of the Russian investment environment consistently confirm the arbitrariness of law enforcement and extent of bureaucratic corruption.[570] Thus, according to Ledeneva, everyone is under the threat of punishment, and so the criteria upon which to decide who to punish becomes a matter of discretion rather than law.[571] The Yukos case is a good example of this.

At a countrywide level, this relationship of mutual penetration is difficult to set right. While state officials retain regulatory power and discretion, the private sector relies on their collaboration, and cannot unilaterally disengage, and try to operate transparently, even if it wanted to. On the state side, administrative reform is a massive challenge. Property rights require a state that is not only strong enough to secure them, but also one that is itself restrained and accountable for its actions.[572] Thus, the securing of property rights requires the state to surrender much of its

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567 The Moscow Times 2004b.
568 BBC News Online 2005a.
569 Ledeneva 2001, 13. See also: The Moscow Times 2005, The Moscow Times 2004h
570 See, most recently, OECD 2004, 60 and FIAS 2005, 10, 12.
571 Ledeneva 2001, 13.
572 Tomspon 2005b, 165

leverage against the private sector, and so the stream of bribes. Unfortunately, the mechanisms for holding the government accountable – the courts, press, civil society and political opposition, are weak, and in President Putin's second term, arguably getting weaker in comparison to the state.[573]

The legal environment that foreign investors encounter in Russia today is shaped by the country's consistent tradition of state involvement in the economy as well as the state's refusal to be bound by legal authority, a feature which dates back to the tsars. Thus commentators say that it is of utmost importance that the state make a credible commitment to abide by the law.[574] Interestingly, this shows that the concept of a Theoretically Ideal Legal Climate in Russia must emphasise protection *from* the state as much as it emphasises the protection of the state. This prevalence of 'might over right' is particularly reflected in the judiciary's lack of independence, which is examined along with other facets of the present day legal climate, in Part II of this Chapter.

7 Summary

Imperial Russia had a strong autocratic tradition which resisted the development of democratic institutions and an independent judiciary. However, elements of a constitutional monarchy based on the seperation of powers was beginning to emerge in the years leading up to the 1917 Revolution, and may have been established were it not for the radical changes that occurred after 1917. Marxism-Leninsim was ideologically and practically opposed to the rule of law and the seperation of powers. The late Soviet years, under Gorbachev, saw a revival of interest in the rule of law. A remarkable amount of positive legal development, not to mention political and economic reform, occurred in the transition period, during the presidencies of Boris Yeltsin and Vladimir Putin. However, much still remains to be done. Finally, the course of events in the last few years have made commentators question the

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573 Tompson 2005b, 164-165.

574 Frye 2002, 125.

commitment of the Putin administration to an accountable, transparent, rule of law state.

PART TWO: Assessing the Present Day Legal Climate

8 Introduction

In this Section, more recent assessments of the Russian legal climate are presented. The Section mainly relates the opinions of foreign investors and foreign commentators, but the perspectives of Russian firms and commentators are also included. Existing research is supplemented by an analysis of Business Environment and Enterprise Performance Survey (BEEPS), a joint effort of the World Bank and EBRD.

The BEEPS is a comprehensive investment climate survey conducted on behalf of the World Bank and EBRD to firms in the transition region. The BEEPS is a multiple choice questionnaire, composed of around 200 individual questions; the survey was first conducted in 1999, then in 2002, and most recently in 2005.[575] The study is extensive: BEEPS I surveyed over 4,000 firms in 22 countries of Eastern Europe, the former Soviet Union, and Turkey, while BEEPS II was applied to 6,000 firms in 28 countries in the same region.[576] The responses to the questions, along with interactive tools for analysing them are made available on the World Bank's website.[577] The Bank's efforts in making this data accessible to the public, and the tools they have provided to enable researchers to analyse the data with ease, must be lauded.

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575 Although the BEEPS III was conducted in 2005, detailed results were not available at the time of writing.

576 Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FR Yugoslavia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgizstan, Latvia, Lithuania, Moldova, Poland, Romania, Russia, The Slovak Republic, Slovenia, Tajikistan, Turkmenistan (discontinued), Turkey, Ukraine and Uzbekistan.

577 The dataset and related publications can be found within the World Bank's 'Governance & Anti-Corruption' website, at http://info.worldbank.org/governance/beeps2002/

The purpose of the BEEPS survey is to generate measures of the quality of governance and the investment climate. As with most of the World Bank's measures, the BEEPS is based on private sector perceptions.[578] The research is an ongoing World Bank project, and part of a myriad of the Bank's data tools aimed at generating comparative measures of the quality of governance and the investment climate across the world. The scale and comprehensiveness of the BEEPS is its main advantage. The survey includes 82 foreign investors in Russia alone. It analyses the legal climate in some detail as well – it poses over forty questions relating to the legal system. Needless to say, it is not feasible for a single researcher to conduct a study on such a scale in Russia.

Though the BEEPS does not provide answers for the main research agenda of this study, it does provide a excellent background to foreign investors' perceptions of Russia's legal climate. For this reason, it serves as a valuable introduction to the issues discussed in greater depth in the field interviews. For example, the BEEPS identifies specific problems in Russia's legal and regulatory environment while the interviews explain how investors respond to these challenges. The data analysis is available on file with the author.

It can be said that Russia is not one country, but 89 regions. It is very difficult to generalise about the legal system of a country that spans eleven time zones, from Finland to Japan. Whether it is for reasons of geographical diversity, the rate of legal and regulatory change or the sheer complexity of the legal environment, assessments of Russia's legal climate are mixed. One commentator provides a welcome note of caution:

> "There is a serious danger that contemporary concepts of Russia will be grossly distorted under the impact of several simplified stereotypes prevailing in the minds of scholars studying the Russian state and its law. These stereotypes include, above all, the belief that violations of the law are universally widespread and the machinery

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578 World Bank Institute internet site, page on 'Governance Data' visited on 14/8/05.

> of state is totally corrupt. The actual state of affairs is more complicated; yes, both violations of the law and corruption coexist simultaneously in contemporary Russia. But these are not the phenomena that determine the legal background and ambience of the country. *In truth, what determines the character of contemporary Russia, in this regard, cannot be clearly defined and may be distinguished from lawlessness and corruption at an empirical level only with great difficulty."*[579] [Emphasis added].

Keeping in mind then the inherent difficulty of accurately measuring the quality of legal systems – a point which has also been addressed elsewhere in this study,[580] we proceed to analyse perceptions of the Russian legal climate. The following sub-sections present assessments of 'laws and legal stability', 'courts and law enforcement', 'bureaucrats and bureaucracy' and 'corruption' in turn. While the division is necessary to provide structure, the reader will appreciate that these are very much interconnected issues.

8.1 Laws and Legal Stability

First, the scope and quality of business laws. In 2001, the OECD judged that commercial legal rules in Russia were "sufficiently clear, coherent and operational to support business activity in general."[581] Despite some legislative gaps, the right laws are apparently in place.[582] Gaps in legislation exist in the sphere of corporate governance, including shareholder rights and labour rights.[583] Intellectual property legislation is also due to be amended.[584] Perhaps due to inconsistency in the interpretation of laws and regulations, some commentators claim that laws are conflicting, overlapping and changing.[585] Accordingly, a commercial report on Russia's investment climate argued that harmonisation of laws with legal practices would particularly benefit foreign investors.[586]

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579 Pastukhov 2002, 1.
580 Chapter Three, subsection 1.1.1.
581 OECD 2001, 7.
582 Schaffer *et al.* 2004, 8, EBC 2002, Hertzfeld 2000.
583 OECD 2002b.
584 Novosti 2005.
585 US Department of Commerce 2001; OECD 2002, 33.
586 EIU 2003.

Evidence from foreign investors themselves shows that they perceive that Russia lacks legal and regulatory stability. For example, one survey of European investors identified the "inadequate and ever changing" tax laws as the biggest obstacle faced by respondents.[587] In another survey of European investors, by the European Business Club in Russia (EBC), legal instability was ranked as the fifth of ten obstacles to business.[588] In the same study, foreign investors complained about the complexity of the legal system and legislation, as well as about the lack of information about changes in government policy.[589] The 2002 World Bank 'Business Environment Snapshot' shows that only 25% of foreign investors agree that government officials' interpretations of regulations are consistent and predicable. Most recently, an 2005 OECD survey of 102 foreign investors, found that half the sample felt that legal and regulatory changes as well as delays in licensing and registration were a 'medium to severe problem'. The survey also found that lack of predictability of the customs rules and regulations was more aggravating to foreign investors than the extent of corruption.[590]

Foreign Investor Perspective from the BEEPS

Only 16% of foreign investors in the BEEPS study felt that government officials' interpretations of laws and regulations were consistent and predictable. While there is a widespread perception among foreign investors that Russia lacks legal stability, there is not a similarly widespread view about its impact. For instance, the BEEPS asks: *"How likely do you think it is that an unforeseen change in laws or regulations will occur in 2003 and have a significant impact on your business?"* Only a slight majority, 54%, felt it was at all likely.

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587 Ahrend 2000.
588 EBC 2003, 31.
589 EBC 2003, 21.
590 OECD 2006, 26-27

8.2 Courts and Law Enforcement

A review of judicial reform in Russia argued that the main obstacle to a Theoretically Ideal Legal Climate in Russia was the susceptibility of the courts to outside influence – the prevalence of "might over right".[591] A chorus of commentators agree that judges are neither independent within the judicial hierarchy, nor isolated from influence from other branches of government.[592] Experts claim that it is hard to obtain independent dispute resolution, and that the courts are subject to political pressure.[593] Recent judicial reforms, such as removing regional governors from the appointment and promotion process and reducing the courts' reliance on regional and private funds, demonstrates that policy makers accept the need for greater judicial independence.[594]

The impact of 'might over right' is manifest in private sector disaffection with the judicial system. In a study on perceptions of the courts, 66% of local respondents to the question *"based on your experience and the experience of your colleagues, do you think that pressure is put on the decisions of the arbitration court in your region?"* said that they did think that pressure was applied to courts, especially by governors, politicians, government officials and influential business people.[595] As a consequence, the public are to some extent alienated from the courts: in another survey, 79% of respondents agreed with the statement *"many people do not resort to the courts because they do not expect to find justice there."*[596] Other studies have also found that local businesses use the courts much less than they need to.[597] Echoing the point made earlier about public cynicism towards authority, it is suggested that Russians avoid the courts

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591 Holmes 2002, 91.

592 For example, Krasnov 2002, 94; Berglof *et al.* 2003, 83-86; S&P 2004, 2.

593 US Department of Commerce 2001.

594 Solomon 2002, 122.

595 Frye 2002, 128.

596 Frye 2002, 94.

597 Frye & Schleifer 1997 find that 45% of shopkeepers surveyed in Moscow said they needed to, but did not use the courts in last two years, compared to 10% in Warsaw. Similarly, Frye & Zhuravskaya 2000, 494 find that 49% of surveyed in Moscow said they needed to, but did not use the courts in last two years, as opposed to 20% in Smolensk.

because Russians they are unwilling to expose themselves and especially their financial affairs to the legal system and the 'predatory' state.[598]

An issue that relates to the partiality of the courts is that firms feel more confident in disputes with private firms than they do in disputes with government bodies. Frye finds that 38% of businesses surveyed felt that a court could ensure compliance if a decision goes against the local/regional government, while 84% felt confident in compliance against a business partner.[599] Similarly a Moscow think-tank found that, in contesting the actions of government officials only 6% initiate court proceedings, while 13% initiate administrative appeal, 25% use personal connections and 23% use gifts.[600]

There is a widespread belief, among Russians and the foreign investment community, that the enforcement of laws is currently of greater concern than their actual content.[601] Observers point out that laws are not applied uniformly by the judiciary, but in an arbitrary and inconsistent manner.[602] As a result contracts can be hard to verify and enforce.[603] Moreover, even if one does obtain a favourable court decision, it if often hard to execute,[604] and is likely to require payment of a bribe.[605] A combination of factors conspire to render the courts ineffective: delays, weak enforcement mechanisms (such as bailiffs), inadequate funding and remuneration, unfamiliarity with new and often poorly drafted legislation,[606] as well as the corruption and partiality that has already been mentioned. Judicial reforms have addressed some of these constraints, notably, funding and incentives for judges and

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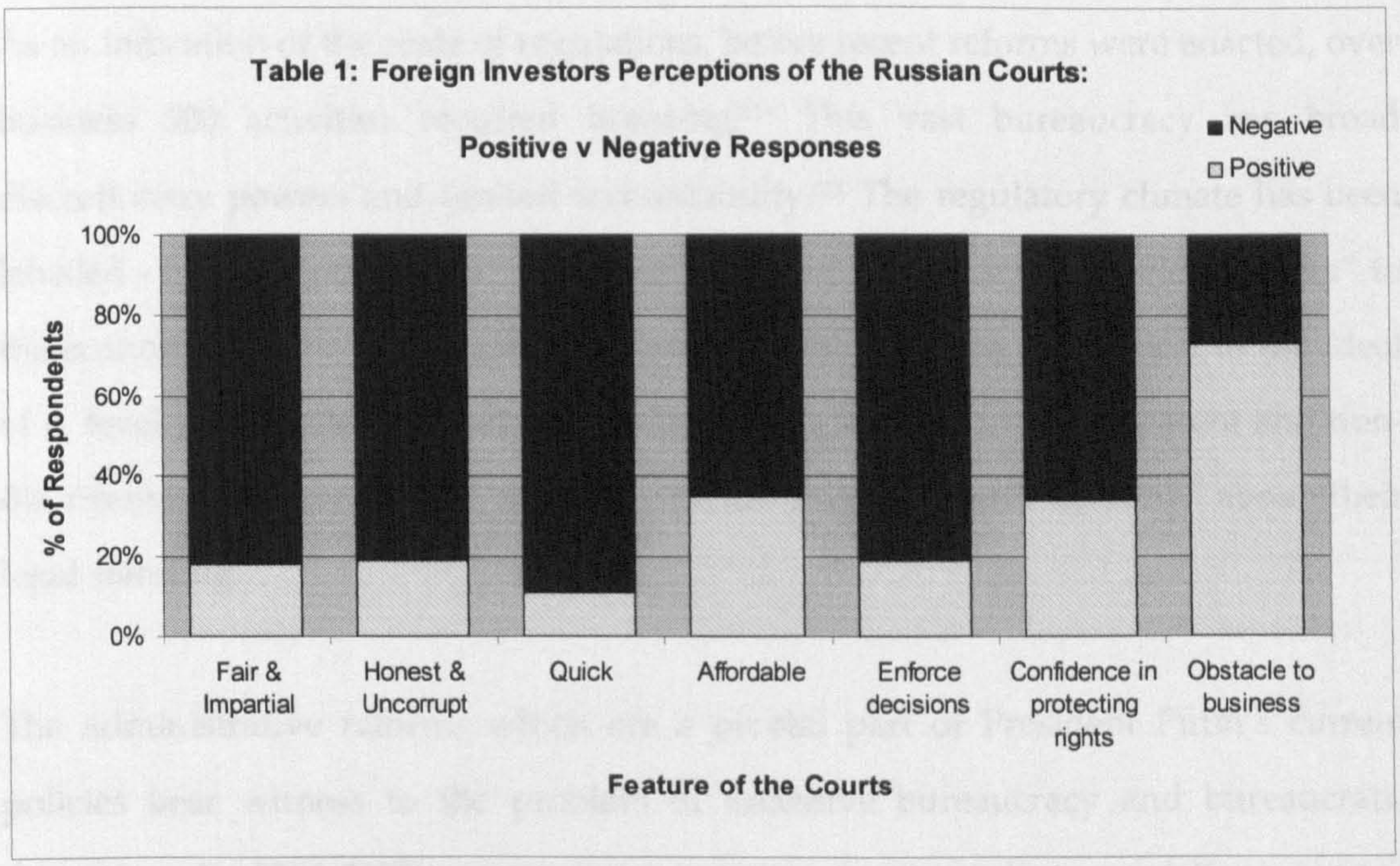
598 Hay & Schleifer 1998, 398.
599 Frye 2002.
600 Reported in Berglof *et al.* 2003, 85.
601 Schaffer *et al.* 2004, 8; EBRD 2002a; EBC 2002; OECD 2002b, 33; Hertzfeld 2000.
602 Doyle 2003; Economist Intelligence Unit 2003; OECD 2001, 5-6 and 16-17; Levin & Satarov 2000, 6-7.
603 OECD 2004, 60
604 OECD 2001, 16; US Department of Commerce 2001.
605 OECD 2004, 60
606 Berglof *et al.* 2003, 72, 80-84; OECD 2001, 16-17; Levin & Satarov 2000, 6-7.

bailiffs.[607] In the 2005 OECD survey cited earlier, foreign investors complained in particular about the perceived lack of uniformity and impartiality of the courts, and more so, their perceived slowness and ineffectiveness.[608]

Foreign Investor Perspective from the BEEPS

Table 1, below, presents the BEEPS' findings about the quality of the judiciary. The six multiple choice response options have been divided into three 'negative' responses and three 'positive' ones.[609] As the predominance of the dark over light areas illustrate, the perceptions are overwhelmingly negative.

Table 1: Foreign Investors Perceptions of the Russian Courts:



Source: World Bank, Business Environment and Enterprise Performance Survey

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607 Berglof *et al.* 2003, 88-96; Solomon 2002 119-121.

608 OECD 2006, 26-27

609 For example, on the questions about whether the courts were fair/impartial, honest/uncorrupt, quick, affordable, and whether the respondents had confidence in them, the responses 'never' or 'seldom' were classified as negative, while the responses, 'sometimes', 'frequently' and 'usually' were classified as positive. On the question of whether the courts were an obstacle to business, the responses 'no' and 'minor' were classified as positive, while the responses 'moderate' and 'major' obstacles were classified as negative responses.

It is interesting that, despite the negative assessments of the courts, 73% of foreign investors perceive the judiciary to pose either 'no obstacle' or only a 'minor obstacle' to their business growth. This is shown by the last bar on the right. This suggests that the courts are not of great importance to foreign investors.

8.3 Bureaucrats and Bureaucracy

Bureaucratic discretion and interference is a definitive characteristic of Russia's regulatory and legal climate. The Russian civil service numbers one and a quarter million, which is greater in number than the Soviet Union's bureaucracy, despite the abandonment of command economy and the latter's larger population.[610] Bureaucratic interference is propped up by the sheer weight of regulations in Russia. As an indication of the scale of regulations, before recent reforms were enacted, over business 500 activities required licensing.[611] This vast bureaucracy has broad discretionary powers and limited accountability.[612] The regulatory climate has been labelled - by academics - as a "monstrosity"[613] and the cause of a "serious illness" to the economy.[614] The bureaucratic environment there can be antithetical to the ideal of a 'level playing field', in which regulations are applied in a transparent and non-discriminatory manner, and thereby provide investors with certainty about their legal standing.

The administrative reforms which are a pivotal part of President Putin's current policies bear witness to the problem of excessive bureaucracy and bureaucratic discretion. In 2001-2002, measures were taken to streamline regulations, curtail discretion and increase accountability.[615] They had mixed results. For example, limitations were placed on the number of business inspections permitted, such as, tax administration, fire and police. The new law resulted in an initial drop in official

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610 EBRD 2004, 14.

611 Berglof et al 2003, 103.

612 Berglof *et al.* 2003, 98. The findings of fieldwork for this study, presented in Chapter 5, make the same point.

613 Berglof *et al.* 2003, 97.

614 Pastukhov 2002, 7.

615 Berglof *et al.* 2003, 102-104.

inspections, however, its impact was undermined by an increase in inspections without warrants, as well as an increase in fines and bribes.[616] Similarly, reform of licensing reduced both the number of activities requiring licenses and their fee, and extended the term of licenses. However, again, a study measuring the impact of the reforms found mixed results: while the process did in fact become streamlined, with fewer firms having to apply for licenses, the money and time costs of applications also increased over the period 2002-2004.[617]

Numerous observers draw attention to the arbitrariness and intrusiveness of bureaucracy as a problem for investors.[618] According to a leading business association, the Russian Union of Industrialists and Entrepreneurs, *"foreign companies are getting lost in our administrative tangle as they do not know whom to apply to, how to ensure the adoption of a desired decision, (according to) which rules to play."*[619] Not only is bureaucratic discretion a cause of uncertainty for businesses, but excessive and complex regulations also fuel corruption.[620] In the EBC study cited earlier, bureaucracy was the second biggest obstacle of ten to current foreign investors.[621]

Foreign Investor Perspective from the BEEPS

The BEEPS measures the regulatory burden: it shows that the requirements of regulations occupies 10% of senior management time. Table 2 compares the extent to which different aspects of the regulatory environment are felt to be obstacles to foreign investors' businesses. The chart shows that tax administration and regulatory and economic policy uncertainty and customs/trade regulations are the issues that have the most notable effect on the majority of foreign investors. In fact,

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616 CEFIR 2005, 6

617 CEFIR 2005, 7

618 Doyle 2003, EBC 2003, 31; EIU 2003; OECD 2001, 5-6.

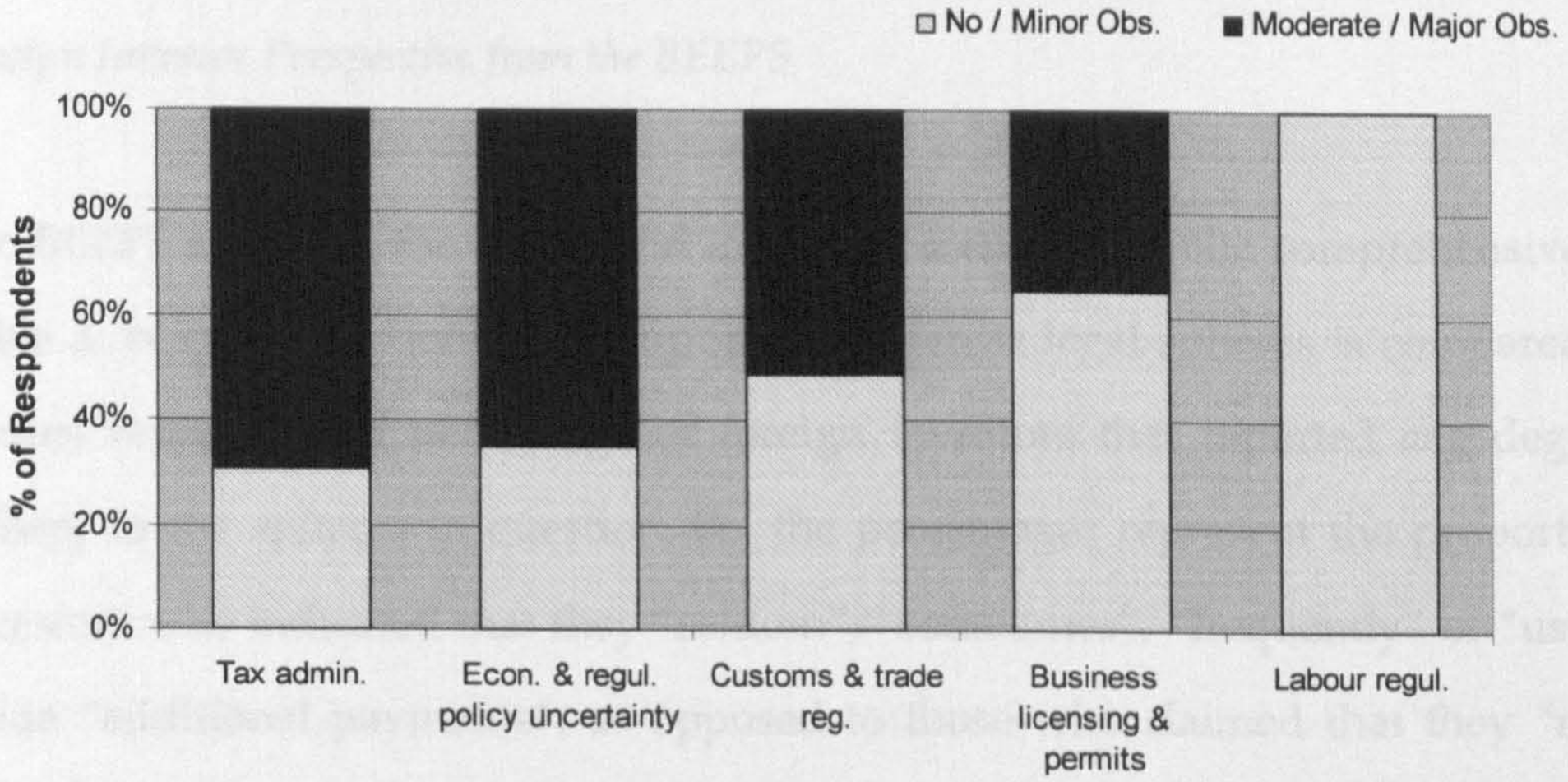
619 Quoted in OECD 2004, 61

620 Berglof *et al.* 2003, 99-102; Black & Tarassova 2002, 13; see also, Hessel & Murphy 2002, who chart a positive linear relationship between the increases in government discretion and corruption, and also demonstrate that both phenomena feature strongly in Russia. For an insightful account of how bureaucracy affects everyday lives in Russia, see Pastukhov 2002.

621 EBC 2003, 31.

regulatory and economic policy uncertainty and tax administration rank as the top two of twenty one obstacles to business assessed in the BEEPS, overshadowing factors such as the courts (13th) and corruption (14th).

Table 2: Foreign Investors' Perceptions of Regulatory Obstacles



Legal Obstacles to Business Growth

Source: World Bank, Business Environment and Enterprise Performance Survey

8.4 Corruption

Commercial studies have labelled corruption in Russia as "endemic"[622] and "rampant"[623]. According to the Russian Union of Industrialists and Entrepreneurs, its impact on small and medium size businesses is "devastating."[624] A Russian research which organisation which has tried to measure corruption estimates that businesses paid an astonishing $316bn in bribes during 2005, which if correct, amounts to almost half of the World Bank's estimate for that country's entire income for the year.[625] Multilateral institutions such as the EBRD and OECD agree that corruption there is

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622 A.T. Kearney 2003, 21.
623 McKinsey 1999, 3.
624 The Russian Union of Industrialists and Entrepreneurs, quoted in OECD 2004, 61
625 Indem 2005. World Bank Internet Site: Data & Statistics, Russian Federation.

pervasive.[626] In 2004, according to Transparency International, the corruption watchdog, Russia was the joint 90th most corrupt country out of 146 worldwide; the following year it had fallen to the 126th. [627] However, echoing the cautionary note at the beginning of this Section, it has been said that studies based on the opinions of foreign experts often find Russia to be more corrupt than surveys of actual business people in the country.[628]

Foreign Investor Perspective from the BEEPS

The BEEPS examines the extent and impact of corruption quite comprehensively. In Table 3, below, the extent of corruption in different legal spheres is compared. The figures represent the percentage of foreign investors that reported *any* degree of bribery in the spheres in question. So, the percentages represent the proportion of investors who indicated that they "seldom", "sometimes", "frequently" or "usually" made "additional payments", as opposed to those who claimed that they "never" paid bribes. Figure 3 shows that bribery is most frequently paid to deal with taxes and tax collection, customs and imports, and to obtain business licences and permits.

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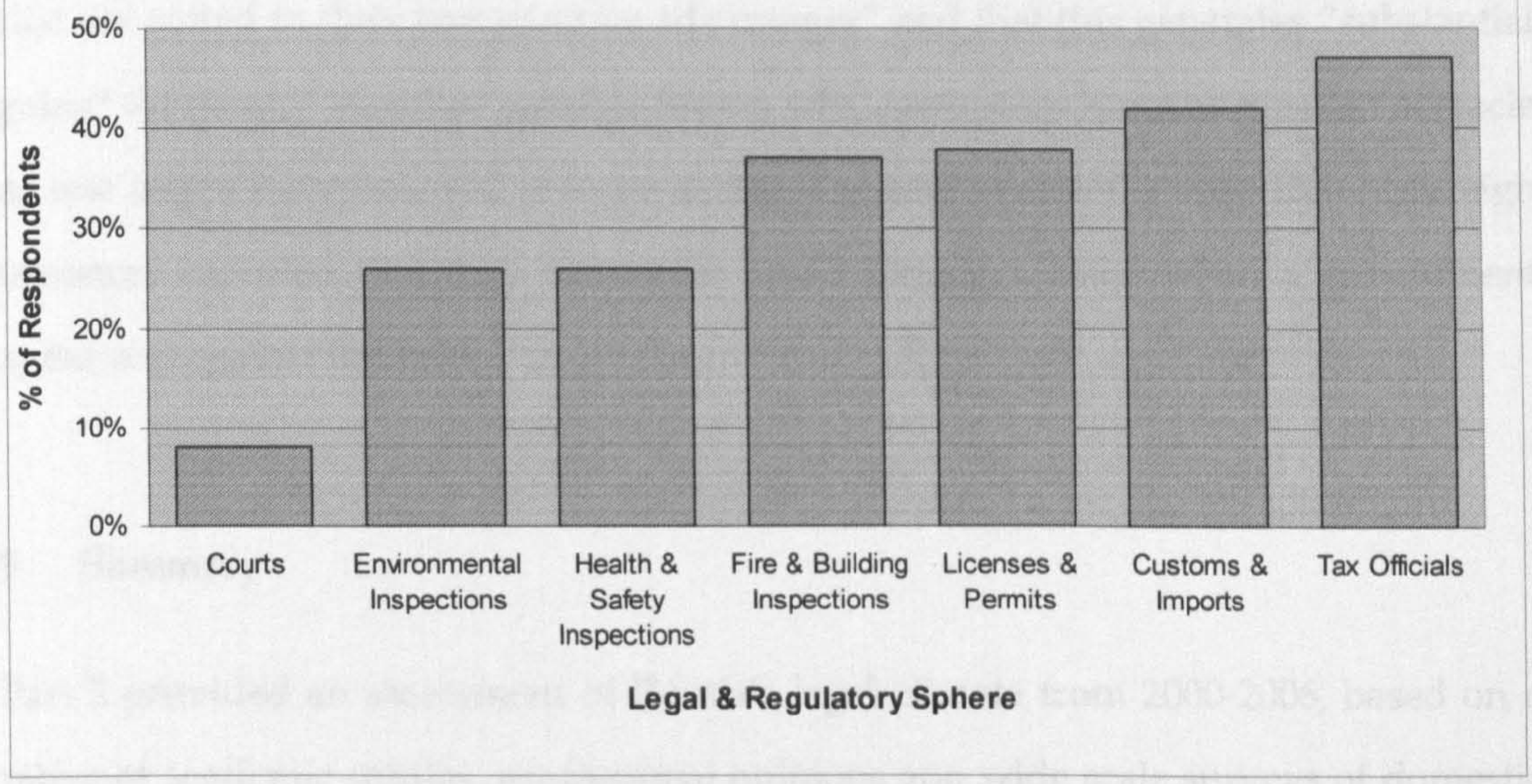
626 Schaffer 2004, 9 analysing World Bank data; EBRD 2004, 14; OECD 2001, 5-6.
627 Transparency International 2004 and 2005
628 Schleifer 2004, 23.

Table 3: Foreign Investors Reporting Any Frequency of Bribery



Source: World Bank, Business Environment and Enterprise Performance Survey

A further point, not illustrated by the diagram, is notable. On average, 32% of foreign investors paid bribes across these spheres. However, these questions under-represent the degree of corruption, as, when asked the general question of whether the firm "pays additional payments to get things done?", 73% of foreign investors indicated some degree of corruption.[629]

Despite the pervasiveness of corruption, 49% of foreign investors in the BEEPS cite corruption as 'no obstacle' to their business, and a further 25% as a 'minor obstacle'. The reason for this might be that corruption serves to a degree to alleviate the onerous tax and regulatory burden in Russia. In fact, corruption ranks as the 14th greatest obstacle to business, while tax administration and regulatory and economic policy uncertainty rank first and second, respectively. Similarly, it has been said that as a result of the red tape in Russia, *"in an overwhelming majority of cases, it is necessary to pay [bribes] not to obtain something contrary to the law, but in order to defend one's*

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629 It is possible, but unlikely, that the authors of the BEEPS questionnaire have omitted a sphere which is particularly corrupt.

lawful interests."[630] Hellman *et al.* offer another explanation. Commenting on the BEEPS evidence, they argue that foreign investors "undertake forms of corruption that are suited to their comparative advantages" and that this generates "substantial gains" for them.[631] Another possible reason why corruption is not as great an obstacle as one might have believed it to be is that it is also avoidable: only 15% of foreign investors reported that they can never avoid paying a bribe when a government agent acts against the rules.

9 Summary

Part 2 provided an assessment of Russia's legal climate from 2000-2006, based on a range of academic studies, professional opinions and wide scale surveys of domestic and foreign firms operating in Russia. The breadth and depth of the studies offer the best assurance that the assessments are as accurate as possible. The BEEPS provides an incisive account of foreign investors' perceptions the Russian legal environment. Table 4 below shows that the most significant obstacles within the investment climate of the twenty-one covered by the BEEPS, exist in the tax and regulatory spheres. Notably, though the Dominant Theory emphasises the quality of the courts and extensiveness of corruption, as far as investors are concerned, the regulatory environment is much more of a problem.

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630 Pastukhov 2002, 3.

631 Hellman *et al.* 2002, 21.

Table 4: Constraints on Foreign Investors' Business Growth

1	Tax administration
2	Economic and regulatory policy uncertainty
3	Tax rates
4	Macroeconomic instability
5	Customs and trade regulations
6	Contract violations by customers & suppliers
…	
8	Business licensing and operating permits
…	
13	Functioning of the judiciary
14	Corruption

Source: World Bank, Business Environment and Enterprise Performance Survey

A particularly interesting aspect of the BEEPS' findings is that there is a marked discrepancy between how poorly foreign investors *describe* features of Russia's legal climate versus how significant investors feel the *impact* of these same features to be. The features of the legal climate are generally described as very poor. This would lead us to expect that their detrimental impact would be particularly significant. Surprisingly, however, as the next paragraph shows, the perceived impact of the these features is not in fact so bad.

For instance, while laws and regulations were overwhelmingly perceived to be interpreted inconsistently, only a slight majority of foreign investors felt that this would impact their firm in the following year. Next, despite the fact that over 80% of foreign investors held negative views about the honesty of the courts, 73% felt the courts were either no obstacle or a minor obstacle to their business. This suggests that the courts are of limited relevance to foreign investors. Similarly, while 59 of the 76 respondents admitted to paying bribes, with greater or less frequency, almost the same number, 58, felt it was either no obstacle or only a minor obstacle to their business.

Part II reveals three interesting and important points. First, it shows that foreign investors are more concerned about the impact of the regulatory environment and government administration than they are about the quality of the courts, and corruption *per se*. This is notable because the Dominant Theory stresses the latter points. Second, the Dominant Theory assumes that a legal climate that is perceived as poor is both very damaging to investors, and therefore also an investment deterrent. However, the points observed in the preceding paragraph suggest that the Russian legal climate, despite its flaws, does not have as great an impact on foreign investors as we might assume. This is because, as Chapter Four explained, a Theoretically Ideal Legal Climate is not the *only* way of securing efficiency and predictability. The final point is that these surveys typically tell just half the story - they do not explain how foreign investors respond to the legal climate.

To conclude, further, in depth, research is required in order to fully appreciate how the Russian legal climate affects foreign investors, in particular: by clarifying how foreign investors' characteristics affect their perceptions; by identifying which aspects of the legal climate are more or less challenging; and finally, by understanding what strategies foreign investors use to navigate the Russian legal climate.

The next Chapter looks at the role of law in Russia from another perspective: by examining the prescription of the Dominant Theory, that is, the question of establishing a Theoretically Ideal Legal Climate.

Chapter Six

The Challenge of Establishing a Theoretically Ideal Legal Climate

1 Introduction

The Dominant Theory argues that to attract foreign investment into Russia, a Theoretically Ideal Legal Climate needs to be firmly established first.[632] Crucially, despite giving this prescription, the advocates of the Dominant Theory never seriously take into consideration the prospects of establishing a Theoretically Ideal Legal Climate in Russia. In fact, the literature on the determinants of foreign investment, and declarations of the Dominant Theory are notably divorced from the extensive literature on transition legal and judicial reform, especially the more critical commentary. This research study seeks to integrate these two bodies of literature.

This dichotomy between the two spheres would not have been problematic if a Theoretically Ideal Legal Climate were a commodity that could quickly and easily be acquired and put in place. Unfortunately, it is not, and we should not take for granted our ability to establish a Theoretically Ideal Legal Climate in Russia in the near future. In fact, this Chapter argues that establishing a Theoretically Ideal Legal Climate in Russia is an immense and complex, long term endeavour. The Dominant Theory's credibility and value is undermined in so far as its solution to attracting foreign investors in Russia has proved so elusive and will remain so for the foreseeable future.

Before proceeding it is important to underscore the links between the Dominant Theory, on foreign investment, and what can be referred to as the "rule of law orthodoxy", on legal reform. As Chapter Two demonstrated, the Dominant Theory derives from traditional law and economics. This classical approach holds that the legal system is important in determining economic behaviour and development; the theory that law is a determinant of foreign investment, is therefore a derivative of this more universal view. With the aim of spurring economic development, this universal view has inspired legal and judicial reform in developing countries; this is

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632 World Bank 1999, 1-2.

what Upham labels as the "rule of law orthodoxy".[633] This approach, stemming from the same school of thought as the Dominant Theory, shares a range of similarities, which shall be expanded upon later.

The point to note here is that the focus of this Chapter has broadened from foreign investment determination, to consider the establishment of the conditions allegedly needed to attract foreign investment, the Theoretically Ideal Legal Climate. With this change in focus comes a change in terminology. Instead of the Dominant Theory, this Chapter examines its counterpart in the sphere of legal reform, the so-called 'rule of law orthodoxy'. The rule of law orthodoxy is the name given to the legal reform approach that has dominated the transition period. This approach hinges on the importance of pristine formal legal systems for economic development, believing in the instrumental ability of legal reform to affect a change in behaviour. Aspects of the rule of law orthodoxy will become clearer as we proceed. Finally, instead of using the term the Theoretically Ideal Legal Climate, which was coined exclusively for foreign investment, we shall refer to the broader and more common term, the rule of law.

A great deal of effort and money has been devoted to developing the rule of law in the transition region. In fact, the keen interest that multilateral institutions and western development agencies took in the legal development process is a defining feature of the transition era.[634] The scale of the World Bank's involvement alone in legal reform within the region is astonishing. By 2001, almost all of the 549 World Bank operations in the region involved some element of legal reform, such as the change of laws, promulgation of new laws, legal education and so on.[635] In the region, between 1990 and 2001, the World Bank lent some $10.8bn for projects which included some aspect of legal and judicial reform. Until recently, the largest loan

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633 Upham 2002.
634 Hendley 2004, 607.
635 Gupta *et al.* 2002, 2.

dedicated to legal reform was given to Russia, for $58m in 1996.[636] In 2005 this was surpassed by a $100m World Bank loan to Russia for civil service reform.[637]

Despite over a decade of legal reforms, the rule of law has not yet been established in Russia. Moreover, the economic disappointments of transition – for instance, the fact that Russia's economy a decade into transition was over 35% smaller than it was when the Soviet Union collapsed[638] - are blamed on the failure to establish supportive institutions. According to some, the legal system is the foremost of the institutions required for transition,[639] and consequently the lack of a supportive legal structure has been labelled the "Achilles' Heel" of transition.[640] This Chapter now attempts to demonstrate the difficulty of the establishing the rule of law in Russia.

2 A Framework for Analysing Legal Reforms

Thomas Carothers provides a useful framework for understanding the challenge of legal reform in Russia. Here we shall use the term 'rule of law reform' to refer to the overall process, of which 'legal reform' is one element. Carothers divides rule of law reform according to its depth. 'Type One' reforms relate to changes in the laws themselves. This typically involves the drafting of new legislation, especially in the economic domain, such as new bankruptcy, corporate governance and taxation laws. 'Type Two' reforms involve strengthening law-related institutions, such as the courts, local government, and law enforcers. The aim is to make them more competent, efficient and accountable. Typical policies include increasing the salaries of judges and court officials, judicial training and legal education. 'Type Three' reforms involve increasing the government's own compliance with the law. Here, government officials must "give up the habit of placing themselves above the law."

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636 Gupta *et al.* 2002, 4.

637 Known as the *Cadastre Development Project* (ID P078420). See World Bank's Russia internet site.

638 Svejnar 2001, Figure 1, 39. Unfortunately a single source of data for Russia and the wider region spanning from the beginning of transition until 2005 was not found.

639 Raiser *et al.* 2000, 18.

640 Svejnar 2001, 8.

Achieving genuine judicial independence is essential to this. While the measures above can encourage this, according to Carothers, the key to Type Three reforms lies in the political domain. The success of such reforms depends less on technical and institutional measures than on "enlightened leadership and sweeping changes in the values and attitudes of those in power."[641]

Carothers' framework is valuable because it provides clarity in understanding the multilayered and multifaceted question of establishing the rule of law. He shows that bringing about the rule of law not only requires legislative change, but also improvements in the effectiveness of law-related institutions, and ultimately, more profound change in the political environment. Legal reform is difficult because the success of Type One reform depends on Type Two reforms, while the success of Type Two reforms in turn depends on their compatibility with Type Three trends. Thus, while technical changes can go so far, their success and the establishment of the rule of law ultimately depends on much deeper change. His framework suggests that establishing the rule of law is a difficult long term endeavour. Russia verifies this hypothesis. Finally, Carothers' approach, if not his exact typology, is supported to by other commentators. For example, Faundez's notion of 'institutional development' combines Type Two and Three reforms. He also argues that the success of legislative reform depends on institutional development.[642]

Rule of law reform being a complex and incremental process, reforms of different Types do affect one another. The processes of lawmaking and institutional building cannot be easily distinguished.[643] While Carothers' framework provides clarity by dividing the issues, it is important to be aware that reforms of different types are interwoven, a point which Carothers himself notes.[644] For instance, reducing regulations, which involves rule changes (Type One), can in principle serve to reduce opportunities for bribery, thereby improving law enforcement institutions (Type

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641 Carothers 1998, 97-98.
642 Faundez 2000, Section 5.
643 Faundez 2000, Section 5.
644 Carothers 1998, 98.

Two). In any case, it is not the purpose of this Chapter to provide a comprehensive framework for understanding rule of law reform. Instead the point is to argue that while the Dominant Theory takes the establishment of the rule of law in Russia for granted, in fact, it is a very difficult and long term endeavour. The next Section uses Carothers' typology as an aide to presenting this argument.

3 The Challenge of Legislative Change

3.1 The Implementation Gap

This sub section demonstrates that the difficulties of transition legal reform have largely been associated with the inability of states to properly implement and enforce the new laws they have enacted. A review published by the EBRD concludes that an overemphasis on legal content over context accounts for the disappointing effects of transplantation in transition countries.[645] It is now widely acknowledged that an effective legal system cannot simply be imported.[646] Establishing the rule of law in transition countries has been difficult as legislative reforms only have a limited effect if they are not supported by strong law-related institutions.

Research shows that legislative change is an insufficient condition for bringing about effective change in legal practices. For example, Pistor *et al.* found that even "radical" and "impressive" improvements in the legal framework for the protection of shareholder and creditor rights in transition countries were insufficient to help newly privatised businesses draw in much needed financing. This was because legal protection formally afforded in the statute books was not correlated with how effective these laws were perceived to be.[647] This is what is often referred to in the

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645 Walsh 2000, 7.

646 See EBRD 2002a, 7; World Bank 1995, 10; Berkowitz *et al.* 2000; Pistor *et al.* 2000, 21; Black & Tarassova 2002, 36.

647 Pistor *et al.* 2000, 14.

literature as an 'implementation gap.' Research has also identified implementation gaps in intellectual property and insolvency regimes.[648]

As an indication of the difficulty of legal reform, it is remarkable that a decade of transition legal reform was required before the implementation gap received attention: as late as 2002, the EBRD admits that legal reformers had "only recently begun" to emphasize implementation.[649] In fact, the effectiveness of legal reform projects was often overlooked in the World Bank's internal evaluation reports.[650] This dichotomy between changes in laws and changes in actual practices is currently one of the most pressing issues in legal reform, and was a central theme of the EBRD's review of the transition decade,[651] and continues to feature in the EBRD's literature.[652] A recent review of transition legal reform demonstrated that the extensiveness of laws outstripped their effectiveness across the entire region, and further, that this implementation gap actually increased between 1999-2002.[653]

Remarkably, both the law reform movement of the 1960's and the contemporary one first focused on legislative change and later realised that legislative changes were being nullified by institutional weaknesses. For example, in their classic 1974 *Scholars in Self-Estrangement* article, Trubek and Galanter argue that:

> "Where it becomes apparent that immediate rule changes will not affect social behaviour, attention shifts to the institutional changes that will be needed to guarantee this will occur. Thus when the literature discusses problems of 'penetration' and legal 'effectiveness' its concern is to narrow the gap between law in action and law in the books."[654]

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648 Economist Intelligence Unit 2003 and Ramasastry *et al.* 2000, 36-39, respectively.
649 EBRD 2002a, 8.
650 Gupta *et al.* 2002, 11-12.
651 EBRD, Law in Transition Autumn 2002, 15.
652 For example, Law in Transition Online 2004.
653 Anderson et al. 2005, 25-25
654 Galanter & Trubek 1974, 1079.

Note the similarity to the EBRD's review of a decade of legal reform, almost thirty years later:

> "The EBRD's early legal surveys and research revealed that the orthodox approach to legal reform, where laws are developed first and implementing institutions strengthened second, needed to be reconfigured, with greater and earlier attention given to implementation and institution building. This revised sequencing of legal reform assistance continues to be supported by the results of the Bank's annual Legal Indicator Survey. Since 1997 the EBRD Survey has revealed a troublingly consistent 'implementation gap' between the extent of new commercial and financial laws and their effective application."[655]

Someone should pose the pressing question of why such evident lessons were not heeded before the World Bank and other agencies committed such great resources to a flawed model of legal reform. In fact, some commentators did caution about transplantation led legal reforms.[656] The point to draw attention to here is that two decades of legal reform activity drew the same frustrated conclusion: that changing the rules does not amount to changing practices. This clearly suggests that legal reform is a difficult enterprise.

Because of the importance of implementation, Faundez argues that the legal reform agenda today is much broader than in the past. For new legislation to work, institutions must be strengthened. Combining Type Two and Three reforms, Faundez argues that reformers must look beyond the "limited confines of the legal doctrine and consider the compatibility of the new rules and institutions with the rest of their legal and political systems." This stage of reform is slower and more difficult than the earlier phase of legislative change.[657] Among the tasks facing reformers is

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655 EBRD 2002a, 7.

656 See for example, Waelde & Gunderson 1994, 360-362. Even the World Bank seemingly recognised the limitations of legal transplantation and the importance of context. See Shihata 1991, 227-230.

657 Faundez 2000, Section 2.1.

changing the culture of bureaucracy. Indeed, civil service reform is ongoing in Russia.[658]

3.2 Abstract Perspectives on Legal Reform

The disappointments of legislative reform show that when law and legal reform is viewed out of context - especially with the popular but often myopic lens of traditional law and economics - legal change appears to be simple. This abstractness is derived from the same theoretical roots of the Dominant Theory, and has parallels with the way in which foreign investors are expected to perceive and respond to the host legal system. It will now be shown that reformers in transition countries overlooked local context and how law is used in society. The challenges of rule of law reform become more apparent as one steps away from this abstract approach, towards understanding how law is actually used (or misused) in Russia, and what the broader influences on the development of the rule of law there are.

Commentators often criticise the advocates of the rule of law orthodoxy for their "misplaced devotion to theory."[659] Faith in legal transplants is an example of how an out-of-context approach can create the misleading impression that rule of law reform is straightforward. It was felt that the collapse of Communism left a *tabula rasa* for legal reform: an opportunity to "design comprehensive academic wish-lists and intricate models of theoretical perfectionism."[660] This approach views law as a force that can be manipulated to govern behaviour, and as the only means of rapidly and directly affecting the changes needed for development.[661] According to Carothers, most policymakers view institutional change in this mechanical way.[662] Upham also characterises the rule of law orthodoxy as a view of law as a 'technology', something that can be acquired, transferred and put in place, like good business practices.[663]

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658 One example is the *Cadastre Development Project*. See World Bank's Russia internet site.
659 Faundez 2000, Section Nine.
660 Waelde & Gunderson 1994, 376.
661 Burg 1977, 505-506 and Campbell and Piccioto 1998, 250.
662 Carothers 2003, 9-10.
663 Upham 2002, 8.

Faundez and Garth both argue that despite the consensus among reformers that the local context does matter, in practice, an adequate analysis of the local context was rarely conducted.[664] This claim is verified by the World Bank. Their internal assessors point out that reviews of country conditions were not conducted prior to lending conditioned on legal reform in the region.[665] Upham too argues that the "truth" of law being contextual is absent from the present rule of law orthodoxy.[666]

Failure to appreciate context had a detrimental effect on the outcome of the privatisation process. Joseph Stiglitz argues that proponents of the Washington Consensus failed to understand the social context of reforms. They ignored the views of experts in the socialist economies who held that the Soviet Union's lack of experience with markets, and the absence of the rule of law, an independent judiciary and appropriate institutions, would render genuine reform in Russia very difficult.[667] The position of western economists was that "there was no 'Soviet man,' only 'economic man,' and given democracy and privatization, those 'economic men' who benefited from privatization would create an automatic and irresistible lobbying force for the rule of law."[668] History shows that those who benefited emerged as an overwhelming force *against* the rule of law.[669]

Hence the state of legal systems in target countries were overlooked as reformers felt that the 'right' laws would provide sufficient incentives for economic actors to abide by them; enforcement in this way would be automatic.[670] Hendley is of the view that transition legal reforms were unwaveringly technocratic, based on rigid assumptions of cause and effect. Commercial laws did not meet needs because how law worked

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664 Faundez 2000, Section 5 and Garth 2000, 15-16.
665 Gupta *et al.* 2002, 7-8.
666 Upham 2002, 7-8.
667 Hoff & Stiglitz 2004, 14.
668 Hoff & Stiglitz 2004, 15.
669 Black & Tarassova 2002, Stiglitz 2002, 157-160
670 Hendley 2004, 609-610; Hoff & Stiglitz 2004, 15; Gupta *et al.* 2002, 7

was never explored before privatisation. This, she feels, was particularly unadvisable given the legacy of distrust in state institutions.[671]

Unfortunately, the lessons of transition do not seem to have changed the way that scholars of traditional law and economics think. The analysis that follows offers another example of how an out-of-context approach to legal reform gives the impression that the problem addressed is easily fixed, while a contextualised approach alerts one to the limited efficacy of legal reform. Writing in 2004, Richard Posner propounds the 'rules-first' strategy as a way of trying to get around the problem of weak legal institutions:

> "...since it is much more costly and time-consuming to create efficient legal institutions than to enact efficient rules for the existing inefficient institutions to administer, the focus of reform should be on the latter...The creation and dissemination of a rule involves small fixed costs and (like other information goods) negligible marginal costs, while legal institutions require heavy inputs of high-priced, educated labour."[672]

At first sight, this proposition appears logical. But when one examines it more closely and against the evidence available, its limitations become clear. The concepts that Posner employs are simply too vague: why should we expect that inefficient institutions will administer efficient rules any better than they administered inefficient rules? Do these institutions remain "inefficient" even though they apply the new, "efficient" rules? He views legal reform in mechanical terms and out of context, and in doing so, it appears as an easy task.

Posner makes a further suggestion for improving judicial competence and reducing corruption. He argues that when the "greatest danger to a developing nation's

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671 Hendley 2004, 607-611.

672 Posner 2004, 77. The idea is not original to Posner. In Hay *et al.* 1996, a variation on this idea is presented; the authors suggest that instead of aiming to bring about wholesale change, reformers should start by enacting clear and simple rules that follow business practise. While Posner is referring to legal reform in developing countries generally, Hay's work is based on Russia.

prosperity is the threat that government will confiscate people's property" then a good idea is to create a "special court whose sole mission is to check the government." Further, "if the court is confined to purely economic issues, the political authorities may be willing to tolerate its independence, especially if they understand how much such an institution can do for the nation's prosperity.[673]

Applying Posner's prescription to Russia highlights the difficulty of Type One reform. In particular, it underscores the extent to which rule of law reform depends upon more profound changes. Though the state's infringement on property rights is certainly a central concern in Russia, Posner's suggestions are wholly unworkable in the current climate. It is precisely *because* the issues are "economic" that political authorities intervene and influence the courts; because economic regulation is not confined to the statute books but determines the allocation of vast wealth, power, and in the case of natural resources, Russia's international standing too. In today's Russia such a court would probably just serve as another venue for vested interests. Can such a hypothetical court really exist in a country where "all bets are off" if a legal dispute is at all political;[674] in a legal system which is characterised by "might over right";[675] in an environment where major investors will only commit if they can be assured of support from the President?[676] Is it reasonable to believe that the authorities in Russia will "tolerate" the independence of a court, while in the opinion of the Parliamentary Assembly of the Council of Europe, the state's use of the law in the Yukos affair resembles a co-ordinated attack with the aim of weakening political opposition and regaining control of strategic economic assets?[677] The evidence strongly suggests that the foundations for such a court are not in place in Russia. It also clearly demonstrates the risks of abstract approaches to legal reform.

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673 Posner 2004, 78.
674 Interview LAW 2 (US).
675 Holmes 2002, 91.
676 For example, Interviews FIN 2 (UK) and PRO 3 (UK).
677 Council of Europe 2005.

This Section has shown that legislative change in transition, especially in Russia, cannot be entirely successful unless it has institutional support. Legislative change was undermined because the supportive institutions were not in place, and furthermore, reformers believed that the quality of institutions and the way in which laws were used, abused and avoided,[678] was not important. The abstractness of the legal reform approach has a parallel in the abstract assumptions about the impact of the legal climate on foreign investors. By moving away from an abstract approach to a contextual one, both on the subject of law foreign investment and rule of law reform, one begins to understand the numerous influences that affect the role and impact of the law. The next Section examines whether the support of law-related institutions can be readily acquired.

4 The Challenge of Strengthening Law-Related Institutions

We now move on to examine Type Two reforms, which involve strengthening law-related institutions. Again, as rule of law reform is inter-related process, it is somewhat artificial to divide these types of reform up. Nevertheless, doing so provides the clarity needed to navigate this tricky subject. The strengthening of law-related institutions draws attention to the context in which institutional change occurs. As we shall see, strengthening Russian institutions is itself a challenging task made more so by the fact that success depends on deeper changes in the political, legal and economic environment.

It is useful to start with a standard prescription for Type Two reforms. For example, the OECD's 2004 recommendations for improved corporate governance in Russia:

> "184. Considering the gap between the letter of the law and actual practice, priority should be given to improving implementation and enforcement of existing rules and regulations. This requires a significant empowerment of the judicial system...

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678 This term is borrowed from the title of Perry-Kessaris 2005, *Use, Abuse and Avoidance: Foreign Investors and the Legal System in Bangalore.*

185. The capacity of the judicial system must be strengthened to effectively deal with commercial disputes.

186. ...It is therefore of utmost importance that the Russian judiciary is immediately granted sufficient resources. More specifically, the compensation of judges and other court personnel should be increased...

187. Priority should be given to improving training in commercial law....[679]

The OECD rightly recognises the gap between law on the books and law in action in Russia, and rightly points out the importance of strengthening the judiciary in addressing this gap. The problem with the OECD's prescriptions is that they appear to be unaware of some the lessons of legal reform and Russia. As Carothers pointed out six years previously, the success of Type Two reforms is not simply a matter of resources and training, but depends ultimately on the broader political and legal climate and especially the independence of the judiciary. The World Bank's Director of Global Governance, Daniel Kauffman, also published this view in 2003.[680] But the OECD never mentions the issues of judicial corruption and lack of judicial independence in Russia. In fact, they appear to view judicial empowerment as a policy level that simply needs to be pulled. Thus there is a divide between what is prescribed by commentators and what is known about the feasibility of their prescriptions. This divergence shows why it is important to integrate and share knowledge between neighbouring fields of study.

Analysing rule of law reform within the wider context inevitably adds a great deal of complexity to the issue. Garth argues that the simplistic rhetoric of the rule of law orthodoxy veils "complicated social realities."[681] Similarly, Upham interprets the contextual nature of law as a sign that legal systems are too complex to be planned

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679 OECD 2004, 33.

680 Kaufmann 2003, 21-25 .

681 Garth 2000, 11.

from the top down.[682] We now examine how the strengthening of law-related institutions can be particularly complicated and hard to achieve.

Black and Tarassova, lawyers with first hand experience of reform in Russia, argue that the essence of institutional reform in Russia is its complexity and interrelatedness. They illustrate their point with a chart that summarises all the major aspects of institutional reforms and how they relate. The diagram is an intricate mesh of arrows, with *dozens* of major reforms and *hundreds* of relationships between them. Their message is that "many reforms are needed, most are interconnected, all can't be achieved at once."[683] Addressing the two core law-related institutions, the judiciary and bureaucracy, it will be demonstrated that the reform of these institutions requires a holistic approach and ultimately depends on deeper changes.

Genuine judicial reform depends, *inter alia*, on the development of a free press, the control of organised crime and corruption, civil law procedures, and the development of small and medium size businesses (SMEs).[684] Take one of these elements, SMEs. The development of SMEs depends on numerous factors, including democratisation measures, deregulation, control of corruption and organised crime, fair competition and anti-monopoly policy.[685] But the factors are interdependent: the development of democracy and civil society relies in turn on a more even distribution of financial and human capital, which requires that both SMEs and the middle classes feature much more strongly in Russia's economic and political life.[686]

Administrative reform exists in a similarly complex and inter-dependent world. Regulations in a wide range of spheres, from land registration to business licensing, taxation and customs, must be scaled back and refined.[687] This reform started has been underway in Russia for several years, and is ongoing. The creation and

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682 Upham 2002, 7 and 33.
683 Black & Tarassova 2002, 4.
684 Berglof *et al.* 2003, 76-77; Black & Tarassova 2002, 3.
685 Black & Tarassova 2002, 3.
686 Berglof *et al.* 2003, 149.
687 Black & Tarassova 2002, 3.

enforcement of these regulations turns on the bureaucracy, which inevitably opposes reforms that will reduce its size, influence and opportunities for extra income. Administrative reform will also partly turn on the ability of the courts to see that the new administrative laws are enforced.[688] Thus its success depends on the effectiveness of the judiciary and its independence, as well as economic reforms such as on banking and competition policy.[689]

The control of corruption is seen as a particularly crucial aspect of institutional reform. Corruption undermines reforms by leading to poor policies, poor regulation and legislation, and also weak enforcement of them.[690] Moreover, bribery defends corrupt vested interests both in government and in the private sector. It also erodes trust in society, which is a particularly valuable asset in times of change.[691] Despite giving twenty one reasons for the importance of controlling corruption as a prerequisite to institution reform, Black and Tarassova themselves offer no advice about how to go about accomplishing the agenda they lay out.[692]

The extent of corruption in the legal systems of transition countries has prompted the World Bank to revise its belief in the efficacy of legal and judicial reforms as a means of improving governance. This is a major shift in thinking. Among the interesting reflections in the World Bank's aptly named paper *Rethinking Governance* is the realization that in countries in which legal and judicial processes are "privatized" – that means so corrupt that judgeships can be purchased - legal institutions are actually part of the governance problem, rather than a means of solving them. Thus, Kaufmann argues that the very orthodoxy of legal reform must be rethought. This means that reforms must come from outside of the legal and judicial sphere, for example from a competitive business and financial sector, and from specialised NGOs. Moreover, the encouragement that political leaders require must also come

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688 Berglof *et al.* 2003, 103.
689 Black & Tarrasova 2002, 3
690 Black & Tarrasova 2002, 13-14.
691 Raiser 1999, 6 and 14.
692 Black & Tarrasova 2002, 12-16

from outside the country, with the carrot for rule of law reform being, for example, the prospect of membership of the WTO or EU.[693]

Incentives for reform have so far been difficult to come by in Russia. Hay and Schleifer point out that during the transition period, attempts at strengthening the Russian state backfired because the incentives were insufficient. For instance, as the tax police became more powerful, they also became more arbitrary, abusive and corrupt. When the elite units of the police were armed with new guns with which to combat organised criminals, they simply sold these weapons on to the mafia themselves, earning more than they would when they sold the older guns![694]

A further example of reforms being undermined by the very weakness of state institutions and insufficient incentives can be seen in Russia's 2001-2003 administrative reforms. The Minister in charge admits that despite the changes, there remains many administrative barriers and opportunities for extracting bribes.[695] In the present research, interviewees confirmed that they have yet to feel the effect of the tax, administrative and customs reforms that have taken place.[696] One executive said that the new customs code had not changed how the system worked but that the reforms were merely "glossy".[697] Deregulation did reduce the number of inspections that firms face, but as described in the last Chapter, according to CEFIR, the Russian think tank monitoring the changes, substantial abuses in direct violation of the new laws continue by agencies. For instance, while the number of planned inspections was supposed to be limited to one per year, agencies made repeated, illegal, inspections.[698]

A final complicating factor in Russia comes from the existence of informal institutions. Informal institutions places limits on the efficacy of Type One and Two

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693 Kaufmann 2003, 21-25.
694 Hay & Schleifer 1998, 400
695 The Moscow Times 2004i.
696 Interviews CON 2(US), FDI 7 (UK), JOU 1 (US), FDI 8 (EE).
697 Interview FDI 8 (EE).
698 CEFIR 2003, 5-6; CEFIR 2005, 6

reform in an variety of ways. In so far as they serve as a substitute for formal institutions, informal institutions may reduce demand for the rule of law.[699] In Russia this situation is aggravated by the suspicion that people feel towards officialdom. For example, parties may avoid using courts, not due to their ineffectiveness, but because proceedings expose their financial and regulatory affairs and thus make them targets for predatory bureaucrats and tax inspectors.[700] So mistrust between society and state reduces the effectiveness of top down change without a concomitant change in 'cultural orientations' from below.[701]

Informal institutions can slow the progress of rule of law reform. Societal norms, if they are at odds with the direction of reform, can have a countervailing effect and bring unintended consequences.[702] Further, the more radical the reform, the greater the need for sanction to be perceived by economic actors; this requires a strong state. Hence a weak state like Russia should opt for a gradual approach, keeping reforms close to existing practices.[703] But because policy makers only have direct control over formal rules, they have a limited ability to make the improve the system.[704] Finally, informal institutions themselves do not change quickly.[705]

In summary, the strengthening of law-related institutions in Russia is particularly difficult for a number of reasons. It is a complex process involving many reforms across many spheres, not just legal ones. Further, the outcomes of individual reforms depends on one another. Such reforms in Russia have not been as effective as they need to be. In fact, reforms are undermined by pervasive corruption and the existence of informal institutions. Remarkably, the challenge of institutional reform has led at least on leading figure within the World Bank to question the entire orthodoxy of legal and judicial reform as a means of governance improvements.

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699 Gel'man 2004, 1023.
700 Hay & Shleifer 1998, 399.
701 Gel'man 2004, 1023.
702 Parisi & Von Wangenheim 2004, 2-5.
703 Hay *et al.* 1996, 565.
704 North 2001, 329.
705 Gel'man 2004, 1023.

Finally, and perhaps most importantly, reforms depend on a significant shift in the values of both the state and private sector, an issue which is explored further now.

5 The Challenge of Deeper Change

In the previous Section it was shown that institutional, or 'Type Two', improvements require reform beyond the legal and judicial sector. To be successful, changes need to penetrate to a deep level. This Section develops these arguments further. It is shown that establishing the rule of law in Russia ultimately amounts to a 'cultural' change.

As mentioned at the beginning of this analysis, Carothers characterises Type Three reforms in terms of increasing the state's own compliance with the law, which involves achieving genuine judicial independence. Further, he argued that while Type Two measures could encourage this, in the end, the success of Type Three reforms, depended on "sweeping changes in the values and attitudes of those in power."[706]

Today, commentators agree that the task facing Russia is no less than the reforming the state and national institutions. According to the EBRD, this is the single most important and difficult challenge facing Russia.[707] It is agreed, not least by the Russian government itself, that the further economic development of the country is dependent on the condition of state institutions.[708] The review of the Russian legal climate in the last Chapter drew attention to the characteristics of the bureaucracy and judiciary in Russia. Of particular concern is the behaviour of government officials of all ranks. The EBRD has expressed concerned over, and called for a clarification of, the role of the state in the country's economic life.[709] In short, for the rule of law develop, it is critical that the state itself make a credible commitment to

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706 Carothers 1998, 97-98.
707 EBRD 2004, 20.
708 EBRD 2004, 20; The Moscow Times 2004i.
709 EBRD 2004, 20.

abide by the law,[710] something which it has yet to do. An interviewee summarises the situation in Russia well:

> "We have a lot of laws in this country, but not any law, and we're not going to have any law in this country until the people who write the laws in this country start living under those laws, and when police can stop a minister for a traffic violation, you've got law in this country. Right now that can't happen. When it's *dangerous* for them to take bribes. And that's going to have to come from the top, and at the moment it's not happening."[711]

Literature on institutional change demonstrates the profundity of this Type of rule of law reform. Consistent with what has been argued in this Chapter, North argues that institutional change amounts to a change in *beliefs*. Reforms must cohere with a country's heritage, culture and beliefs. This makes the task of engineering change particularly difficult.[712] Similarly, Carothers argues that law is a "normative system that resides in the minds of citizens" and so reformers should try to "intervene in ways that would affect how citizens understand, use, and value law." Carothers gives the example of improving the compliance with the law. Underscoring the political underpinning of effective rule of law reform, improved compliance requires, in part, that the political processes from which laws comes about be perceived as fair.[713] Interviewees also felt that, what they referred to as, 'cultural' changes needed to occur for the rule of law to be established in Russia.[714] So changes are required both in the values of the rulers and the ruled. Interestingly, one interviewee felt that the reason Russia had improved was a consequence of the influence of young people

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710 Frye 2002, 125.
711 Interview LAW 2 (US).
712 North 2001, 327.
713 Carothers 2003, 8-9.
714 Interview FIN 2 (US).

in business life, who shared a western rather than Soviet outlook on how business should be conducted.[715]

North criticises the traditional economic approach to institutional change, arguing that economists do not understand the importance of a country's history and culture. To North, Russia is an example of the failure of their narrow and abstract approach. For instance, he compares the success of the Czech Republic's transition with the failure of Russia's. He points to how changes in formal rules were undermined by the lack of supportive norms in Russia. He argues that a primary reason for the success of the Czech Republic is that, prior to Communism, it was market economy and democracy. The changes that took place in 1991 were successful because they resonated with norms already in the country's heritage. On the other hand, Russia lacked a suitable precedent in its history for market institutions and so similar legal reforms did not have the same effect.[716] Hay and Schleifer too argue that legal reform in Russia would have been more successful if the country had a "collective memory of law and order".[717] Others have also noted the impact of the differing legal heritages of transition countries on reform outcomes.[718] The review of Russia's legal heritage presented in the last Chapter also emphasised that Russia has had little experience of rule of law and economic freedom, and much more experience of autocracy and the use of law as an instrument of power.

Thinking behind law and development has been influenced by German sociologist Max Weber,[719] whose works has provided an framework for understanding why it was that capitalism had flourished in the West. His work again implies that a rule based legal climate cannot be easily replicated but depends on the broader societal influences upon it. Weber, like North, viewed the law not just in economic terms, but in the broader context of society. The European legal climate was itself

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715 Interview LAW 6 (UK).
716 North 2001, 327.
717 Hay & Schleifer 1998, 4.
718 For example, Berkowitz *et al.* 2000, and Pistor *et al.* 2000.
719 Ahrend & Tompson 2005, 45; Upham 2002, 8.

considered to be the outcome of a mix of religious, political, economic, social and legal traditions;[720] and he maintained that law could only be understood in this wider context.[721]

Not only does a country's heritage matter to its reform prospects, but the climate at the time of reforms also has an impact. According to Trubek, Weber's view of the economic role of law was linked to a laissez-faire economic order, or competitive markets where participants had relatively limited economic power.[722] These conditions differ markedly from those inherited with the demise of Communism in Russia. For example, it was shown throughout the last Chapter that the state maintains a strong influence in the economy. A glance at Russian business headlines amply demonstrates that the climate there can be called anything but laissez-faire![723] Further, recent World Bank research in Russia has shown that the country's economy, over a decade into transition, remains concentrated in the hands of small number of industrial groups.[724] This suggests that Russia is not yet ripe for the development of a Weberian rule-based market economy.

Examining Latin America, Maria Dakolias shows that for legal reform to be successful, they must occur in the background of suitable conditions. She points out that the Latin American region was politically, economically and socially better suited for judicial reform in the 1990's than it was in the 1960's and 1970's. For example, by the 1990's greater economic stability and activity created demand for more formal dispute resolution mechanisms; democracy was more deeply rooted, and so society expected greater accountability from government; civil society and local actors were also more involved in reforms. Hence legal reform can be expected

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720 Trubek 1972, 724.

721 Trubek 1972, 753.

722 Trubek 1972, 752.

723 For example, *Oligarchs on the search for hide-outs as the Kremlin intensifies its tax-recovery warrants* (The Russia Journal, 22 April 2005); *Distrust Keeps Business From Talking to State* (The Moscow Times, September 16, 2004. Page 10) *Small Businesses Harassed in Russia Despite New Deregulation* (Beyond Transition, July -September 2002).

724 World Bank 2004, 118 .

to be more effective when the right conditions are in place.[725] In a study on US legal assistance after the collapse of Communism, Jacques DeLisle also concludes that the viability of legal reform depends on whether appropriate legal, political and economic infrastructures exist and are sufficiently strong.[726]

So, prospects for the establishment of the rule of law in Russia depend, not on policies and reform strategies alone, but on whether Russia is ripe for them. For the rule of law to emerge, the Russian state must make progress towards restraining itself, from the Kremlin down to the junior bureaucrat. Overwhelmingly, the evidence indicates that the Russian state lacks the incentives and ability to restrain itself and make its power more accountable. This is another reason why it is felt that successful institutional reform which will establish the rule of law in Russia is a distant prospect.

6 Can it be Done? And, How Long will it Take?

Literature on institutional change demonstrates that rule of law reform is a long term process. North suggests that between five and fifteen years is required to see changes.[727] Putnam argues that institutional change is to be measured by decades.[728] Minister Gref, the architect of Russia's economic and administrative reforms has said that the Russian state is forty years behind in governance.[729] Interviewees felt that a generation of judges needed to be replaced;[730] others speculated that genuine change would take one or two generations.[731] This is consistent with Tamanaha's argument that the first law and development movement, in the 1960's and 1970's, gave up too quickly. He argues that a decade was not enough to evaluate the success of what

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725 Dakolias 1995, 230.
726 DeLisle 1999, 228.
727 North 2001, 329.
728 Putnam 1993, 184.
729 Citibank 2002, 2.
730 Interview PR0 4 (UK).
731 Interview CON 3 (WE).

"was universally recognised to be a monumentally difficult project."[732] A question that arises - though not for this study - when one considers legal change over protracted periods, is the extent to which law is actually a result, rather than a cause, of other political, economic and social changes.

Finally, it is useful to note the general scepticism of some commentators about rule of law reform. Faundez argues that "while it may be true that, theoretically, market friendly legal systems have some attributes in common; in practice, the interplay between law, the state and markets is complex and far from predictable."[733] Carothers is also sober about the nature of the challenge at hand. He argues that the rule of law is a subject of great conceptual and practical complexity. Further, it can be "extremely" difficult to understand both how the law functions in a society, and also how it changes.[734] Perhaps indicative of the complexity of the subject, while an array of approaches exist, there is, as yet no comprehensive and widely accepted theory of institutional change[735] nor transition.[736] Finally, the pre-eminent scholar of institutions, Douglass North concedes that Russia's failure to establish the rule of law shows that:

> "We do not know how to create a political system that will produce and put into place property rights that will provide incentives for people to be productive, and put into place a judicial system that will make for low cost enforcement of agreements and contracts, both of which are necessary conditions for getting a viable polity. We do not even know how we did it ourselves."[737]

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732 Tamanaha 1995, 473.
733 Faundez 2000, Conclusions.
734 Carothers 2003, 12.
735 Pistor 2004; Burki & Perry 1998, 34.
736 Voigt & Engerer 2002, 151.
737 North 2001, 328.

7 Conclusions

7.1 Summary

Despite much investment in legal reform projects and many years trying, the rule of law is far from being established in Russia. This Chapter presented a series of reasons why we should be very cautious about Russia's prospects for establishing the rule of law in the foreseeable future. Though new market-friendly legislation has been enacted in transition countries, the absence of strong law-related institutions has undermined the effectiveness of the new laws. After a disappointing decade of transition – at least in Russia, attention turned to the hitherto neglected role of legal institutions. There has already been and continues to be policies aimed at reforming law-related institutions, such as the judiciary and bureaucracy, in Russia.[738] However, success of such reforms in the end turns on much wider and deeper changes in the attitudes and behaviour Russian society and government. Therefore it does not appear as though the rule of law can be engineered, although measures can be taken to encourage its development to a certain extent.

To be successful, rule of law reform requires the appropriate environment. Russia, unfortunately, has lacked the legal, political and economic heritage that is congenial to the emergence of the rule of law. It also lacks the present day conditions that commentators say are required to encourage the development of rule of law. Of course, analysis of current political and legal trends in Russia is best left to the experts. Nevertheless, while President Putin has professed his commitment to the 'dictatorship' of law, there is little to convince one that Russia's leaders have the requisite "credible commitment"[739] to the rule of law.

Even if the political preconditions were in place, the sheer complexity and interconnected nature of rule of law reform suggests that the task at hand is both very difficult and slow. It has been noted that rule of law reform requires changes

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738 See Berglof et al. 2003, Chapter 4 for a detailed summary.

739 Frye 2002, 125

outside of the usual legal and judicial arena. In fact, commentators have pointed out that legal and judicial reforms must be accompanied by numerous other factors, for example, greater democratisation, more competition in the business sector, a freer press, and even the emergence of a middle class in Russia. Unfortunately, experts on institutional reform and the rule of law, such as Douglass North and Thomas Carothers concede that we know very little about how to achieve this Herculean task. Finally, the existence of alternatives to the rule of law, in the shape of informal institutions, influence and bribery, undermine the demand for the rule of law and policies themselves.

So far, we have avoided defining 'successful' rule of law reform, except in the circular fashion that successful reform amounts to establishing the rule of law. Indeed, the measurement of the rule of law raises tricky questions such as: how much rule of law does a country need to have in order to attract foreign investment? Or, when do we know that we have achieved the rule of law?[740] Fortunately, we are spared the contentious question of measuring the quality of legal climates by the fact that there is no suggestion that Russia may have yet achieved the rule of law.

A final point of clarification is required. In asserting the difficulty of rule of law reform, this Chapter has inevitably had a pessimistic tone. The intention has not been to be pessimistic about Russia, however. In fact, it must be acknowledged that a great deal has changed in the economic, political and legal climate since the collapse of Communism. For example, one businessman involved in Russia for forty years argued that westerners often do not appreciate the huge progress that Russia has made since adopting a politico-economic system that was the exact opposite of the one that was in place for seventy years before it.[741] There was also a general consensus among interviewees that much in the business and legal climate had

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740 For a critique of numerical legal indicators, see Davis 2004, Hendley 2004, Siems 2004, Perry-Kessaris 2003.

741 PRO 4 (UK).

improved significantly in Russia.[742] Despite this change, however, the rule of law still appears to be a distant prospect.

7.2 Implications for the Dominant Theory

When revisited in the light of these arguments, the merit of the Dominant Theory seems limited. As a rhetorical and normative device the Dominant Theory possesses a value in setting a benchmark and exhorting policy makers to rule of law reforms. But the Dominant Theory neither tells us how to bring about the rule of law, nor what to do if we cannot. It prescribes the rule of law as the only way of attracting foreign investment into a country like Russia. But it appears that the rule of law is a long way off, and it cannot be engineered. Advocates of the Dominant Theory should at least show that they are aware of the difficulty of legal reform. Better yet, just as some commentators have revised their view of legal reform in the light of what has been learned in the field over the course of the transition, the advocates of the Dominant Theory should rethink their prescription for attracting foreign investment. This would make for a more useful and credible theory of the rule of law and foreign investment. Further, it may nurture the development of alternative ideas about how to attract foreign investment. We can conclude that as a normative theory, the value of the Dominant Theory is limited in so far as it does not appreciate the challenge of its own prescription.

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742 For example, LAW 3 (UK), LAW 6 (UK), BUS 3 (US), FIN 6 (US).

Chapter Seven

Researching Foreign Investors in Russia

1 Why Examine the Dominant Theory?

In order to build on the Dominant Theory, it is necessary to examine as directly as possible the issues where the Dominant Theory does not provide satisfactory answers. The interview questions relate to the three limitations in the Dominant Theory that have been raised. The first two issues are:

1. How do foreign investors perceive the host legal climate before investing?
2. Why do they invest in countries that lack a Theoretically Ideal Legal Climate?

Hypothesis One, that "a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia" relates to the two shortcomings above. Hypothesis Two, that "foreign investors' perceptions of the Russian legal climate depend on their firm characteristics" relates to issue number three:

3. What factors affect the importance that foreign investors attach to host legal climates?

Before reviewing the research approach, it is useful to summarise how these issues and hypotheses were arrived at.

The following quote is a succinct expression of the Dominant Theory: *"The sound implementation of rule of law is crucial for the country's investment climate..."*[743]

Chapters Three and Four, however, demonstrated that this Theory lacks a robust empirical base, and has various limitations.[744] This study is not questioning whether Theoretically Ideal Legal Climates are *beneficial* to foreign investment, or whether in an ideal world, foreign investors would rather that hosts be endowed with high

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743 Lemierre 2003.

744 Chapters Three and Four review evidence available.

quality legal climates. Instead, using the Dominant Theory and its limitations as a starting point, this study is intends to: first, assess the importance of the overall quality of Russia's legal climate to the attraction and support of foreign investors around 2004; second, to develop a more accurate understanding and explanation of the relationship between foreign investors and host legal climates.

Chapter Three showed that the claims about the role of law in foreign investment are not supported by robust evidence. It is clear that there is much to be learned about the role of law and foreign investors in Russia. The regression studies gave mixed and conflicting results about the role of law as a determinant of FDI. Further, ten technical limitations in the use of regression studies for our purposes were numbered. The survey evidence was also mixed. Above all, they simply do not answer the central question of foreign investment determination, which is: what is the role of law in the decision to invest? Instead surveys frequently report that, according to foreign investors, the legal climate was an obstacle to business, from which they conclude that it must be deter investors. But such a conclusion is quite plainly undermined by the fact that those very same firms invested anyway.

Chapter Four showed why a Theoretically Ideal Legal Climate may be less important to foreign investors than the Dominant Theory supposes. First of all, the impact of the law on the decision to invest may well be overshadowed by a range of non-legal business considerations. Next, the quality of host legal climates may not affect the choice of host if foreign investors are unable or unwilling to acquire and process accurate information about legal climates in the manner presumed by the Dominant Theory. Further, the absence of a Theoretically Ideal Legal Climate may not prevent an investment if foreign investors can compensate for the failures of the formal legal system by relying upon influence, informal institutions and bribery. Finally, attitudes to the law and legal risk are contingent on the characteristics of the investor itself, for example, its size, culture and features of the investment.

This study has not argued that the quality of the legal climate is irrelevant to foreign investors nor that a 'good' legal system would not be beneficial to FDI, nor that foreign investors would not prefer a Theoretically Ideal Legal Climate. Instead, it is evident that a notable faction of foreign investors are less sensitive than presumed to legal climates, and therefore do not behave in the way expected.[745] This shows that the Dominant Theory does not accurately portray the relationship between foreign investors and host legal climates. In fact, it seems in some cases to overstate the importance of the quality of host legal climates and to oversimplify their impact. Examining the Dominant Theory is important for two reasons: first, in its own right as the prevailing theory of foreign investment determination in the law and development community; and second, because the Dominant Theory has been an influential and integral part of the general belief in the necessity of a Theoretically Ideal Legal Climate for economic development, a concept which is vigorously acted upon in legal reforms funded by public money.

2 Method

2.1 Can Existing Evidence be Applied to Address the Research Questions?

The only survey to partly meet the requirements of this study is the BEEPS, the findings of which were presented in Chapter Five. These survey questions are valuable for understanding in some detail how actual foreign investors perceive the legal climate. For example, one group of questions enable researchers to assess the extent to which firms are burdened by legal factors, and to comparing the impact of legal challenges to non-legal aspects of the investment climate. The second set examine perceptions of particular features of the legal climate, for instance, the honesty of the judiciary, the extent of corruption, or the impact of the regulations. The BEEPS was used in Chapter Five to provide an original and in-depth analysis of foreign investors' perceptions of the Russian legal climate as a background to the main research findings, which are presented in the next Chapter.

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745 A term introduced by Perry-Kessaris, for example Perry 2000b, 790.

While the BEEPS is useful for sketching the perceptions of the legal climate, it is not an appropriate source of data for the research agenda. The first inquiry in this study is on the role of law in the decision to invest. The BEEPS, though, tells us nothing about the accuracy of information that foreign investors had about the Russian legal climate at the time of choosing the investment host. Nor does it tell us anything about the impact of perceptions of the Russian legal climate on the choice of host. In order to assess this, it is clear that we need to inquire about the role of law in the decision to invest as directly as possible, from investors and their advisors.

The second inquiry in this study concentrates on discovering what legal strategies foreign investors use in order to operate satisfactorily in Russia. Again, the BEEPS indicators are inappropriate because they only tell half the story. It interesting to know what percentage of foreign investors in Russia view corruption as a major obstacle to their business, or how often foreign investors go to the courts, and how stable they perceive regulations to be. However, such questions does not tell us how investors invest and succeed in spite of a less than perfect legal system. In fact, none of the questions in the BEEPS really serve this purpose.

A particularly useful feature of the BEEPS is that it records firm characteristics, such as ownership, size and export-orientation. This might have enabled researchers to compare the performance and attitudes of foreign investors in Russia according to these factors. Unfortunately, however, the attitudes of foreign investors there cannot be comprehensively analysed according to firm characteristics, as the World Bank does not reveal the characteristics of the respondents where doing so would compromise their anonymity.

The aim of the BEEPS, like other surveys of its genre, is to assess the quality of the investment climate from the perspective of its 'users' – firms. It does this by looking at the formal legal system only, and concentrating almost exclusively on problems. In contrast, the aim of this study is to assess the overall impact of the legal climate on

foreign investors, which requires that we look at both problems and solutions, both the formal and informal spheres. The BEEPS can therefore only be applied to provide us with an introduction into foreign investors' perceptions of the Russian legal climate.

2.2 Methodology

This study uses semi-structured, in-depth interviews to understand and describe the research issues. This research method has its theoretical underpinnings in ethnography. Ethnography is a social science research method in which the researcher involves themselves in the lives of their subject, especially by asking questions.[746] Ethnography also lends theoretical support to the use of multiple data sources. For example, by combining the BEEPS with the interviews, we can compare and 'triangulate' findings, which serves as the most effective way of validating them.[747]

The descriptive nature of ethnographic fieldwork is said to be particularly valuable in challenging "misleading preconceptions" that are often brought to research.[748] Indeed, here it has been argued that the Dominant Theory lacks descriptive power, and that the presumptions of existing research need to be questioned by means of an alternative, more exploratory research approach. An exploratory and descriptive approach is suited both to the development and testing of theory.[749]

Ethnography also sanctions a responsive fieldwork approach. Researchers may find that unforeseen issues arise during the fieldwork, and may want to respond to them, for example by posing particular questions to test new ideas.[750] I found this to be the case during the fieldwork, and over the course of the month, I adapted the interviews

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746 Hammersley & Atkinson 1995, 1-2.
747 Hammersley & Atkinson 1995, 24.
748 Hammersley & Atkinson 1995, 23.
749 Hammersley & Atkinson 1995, 20 & 23.
750 Hammersley & Atkinson 1995, 23.

and made efforts to find particular interviewees in order to better understand issues that I felt needed more attention.

2.3 Fieldwork Attempts

The most obvious way of gauging the role of law in the foreign investment decision process is to interview recent investors or those that are in the process of investing. Both of the techniques were attempted and abandoned. The intention was to interview British firms at their UK headquarters. The survey therefore required a sample list of recent British investors, and another of businesses that were in the process of investing. There is no single source to identify all recent British investors in Russia. Firms incorporated in Russia must register at the Russian *State Registration Chamber,* who are supposed to make these records available for a nominal fee. However, despite repeated attempts from the UK and Russia, it was not possible to obtain a list of recent British investors from that source.

Instead, a number of sources that gave approximate investment dates for British firms were identified and then screened. These sources were the Russian Chamber of Commerce, and three market research firms: OCO Consulting, Dun & Bradstreet and Bureau van Dijk. The firms in their databases were then screened, via their websites and telephone calls, in order to ascertain whether they fit the category of British based foreign direct investors since 2002. Out of an initial total of 203 records, including various repeats, firms that could not be identified, firms that were not British, firms that were not recent investors and so on, only 30 firms remained. Only a single interview came after various attempts at contact via mail, e-mail and telephone. As a result, attempting to address recent British investors in the UK was abandoned. Part of the problem is that not very many British companies have invested in Russia.

It was also impossible to form a sample list of firms in the investment process. Most potential investors will not publicly announce that they are contemplating an investment. Attempts to form a list via investment promotion bodies such as the

Russo-British Chamber of Commerce, the UK government Trade & Investment service, and the Russian Trade Delegation also came to dead ends, because the very limited information they had about companies contemplating investments could not be divulged to third parties.

A business professor also suggested another way of identifying potential investors into Russia. This would start by taking a list of the UK corporations with the most investments throughout the world. This assumes that any company that has made a number of foreign investments might also consider investing in Russia. One could then approach these companies and ask about their perceptions of the country and its legal climate, and the reasons they had not invested, or their investment experience. I did attempt to approach large multinational companies on a few occasions, but it was a frustrating and ultimately fruitless exercise. There were three reasons: first of all, such large companies do not have a division that is called 'foreign investments' and so it is very difficult to identify which department in a company to approach; secondly, a foreign investment is a major strategic decision, usually dealt with at the highest corporate level - this makes it almost impossible for an academic researcher to gain access; finally, firms are secretive about such a significant and sensitive issue as an ongoing or potential investment in a country, again making it almost impossible for a researcher to gain access. The FIAC study cited in Chapter Four did, however, manage to access a large pool of existing and potential investors. However, their study was on a commercial scale, employing twelve researchers from the PBN Company, a consultancy, working for three months in London, Moscow and Washington.[751]

Thus the options for researching the issues were limited by the circumstances. Instead of interviewing recent British investors for the purposes of understanding the role of law in the investment decision process, it was necessary to rely more on foreign investment experts, such as lawyers, private and state investment promoters,

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751 This information was obtained in an email from the PBN Company, the firm which carried out the research. Available on file with the author.

investment consultants, and staff at business associations and chambers of commerce. While necessitated by the circumstances, in some ways this is preferable. Advisors play an integral role in the investment process, and will have extensive first hand experience of it. Unlike most businessmen, who will only have been involved in one foreign investment in Russia, advisors are routinely and professionally involved. Their opinions and experience are therefore particularly valuable.

2.4 Pilot Stage

Given the data limitations, the pilot stage was relatively small. Six interviews were carried out with investors, lawyers, and investment promoters, and there was one consultation with a professor at London Business School with expertise on FDI in transition countries. These helped to decide on the format of the questions and fieldwork method.

2.5 Fieldwork Approach

The fieldwork investigates both the role of the legal system in the decision to invest and engagement with the Russian legal system. In-depth, semi-structured interviews were used. Forty-five interviews were conducted in total - six in London, and thirty-nine in Moscow. The research in Moscow took place over January and February of 2004, and the London component was conducted both before the trip and following up from it.

Interviewees were deliberately chosen for the insights they were expected to have. For instance, one might expect that investment advisors and lawyers would be in a position to identify how foreign investors' approaches differed according to their firm characteristics. The sample list of individual candidates was constructed from various sources: the directories of foreign investors already mentioned; via business associations; the websites of the firms of target interviewees, such as law firms, trade promotion agencies and consultancies; and recommendations. Russia is not a country that is particularly suited to the collection of information, especially about the sensitive topic of businesses and the law. The pool of foreign investors and their

advisors in Moscow is also fairly limited. Candidates were contacted by a combination of telephone, email and fax communications.

The interviews were semi-structured and in-depth. Predominately, they took place at the interviewees' place of work, though a number were conducted in public facilities, such as hotels and cafes. They lasted between twenty minutes to over an hour. Candidates were informed about the purpose of the study, namely doctoral research on foreign investors and the Russian legal climate; this was done at the time of the interview, or when initially contacted, by means of an introductory letter from Dr. Perry-Kessaris. The permission of candidates was always sought to tape-record the interviews, and they were assured of anonymity. I occasionally made hand written notes during the course of the interviews.

I was hosted by a Moscow think tank, the Institute for Complex Strategic Studies (www.icss.ac.ru). They generously provided me with administrative and linguistic support, and assisted in contacting potential interviewees. All of the interviews that are reported in this study were conducted in English.

2.6 Limitations

One of the limitations of this research study is that there is no way of assessing the representativeness of my sample of investors. Ultimately, this is due to the problems mentioned earlier – of compiling a complete list of investors and their advisors. Without knowing the total number and composition of foreign investors in Moscow at that time, it is impossible to gauge the representativeness of the sample. This shortcoming is not particular to my study, but would be a feature of any study on foreign investors in Russia at the time. While the number of interviews conducted (forty-five) is not very large, it is important to bear in mind that towards the end of the research I reached a stage where it seemed that the pool was drying up: I was unable to identify suitable new interview candidates; in fact, I was often being referred to people whom I had already interviewed; and I was not gaining any greater understanding of the issues being researched.

Perhaps the most significant limitation of my research is that it cannot determine the proportion of investors who have turned away from Russia because of their perceptions of its legal climate. The question of whether potential investors turn away from Russia because of their perceptions of the legal was addressed in the interviews, especially with the lawyers, investment promoters and consultants who are often the first point of contact for potential investors. However, these respondents lack knowledge about firms which have not come into contact with. them. Therefore, we cannot know precisely the extent to which foreign firms in general are put off investing in Russia because, for example, they perceive it to be too corrupt. Interestingly, the only large scale survey of foreign firms, the FIAC survey of Russia, also does not present any data on the percentage of potential investors who have decided not to invest because of their perceptions of the legal climate.

Inherent to any research of this type is the self-selecting nature of the respondents. A bias may be incurred from this, for example because those willing to talk to researchers have a particular type of view.[752] One should not expect complete honesty and frankness from respondents.[753] Also, it is possible that Russians may not wish to speak candidly about taboo topics, out of a desire to not present a negative picture of their country. Further, corruption and similar 'contra-normative' behaviour is generally underreported in surveys,[754] and so it may be hard to find candidates that are willing to talk openly about opaque practices.

It may be possible, however, that with right approach these barriers can be overcome.[755] Interviewees must trust the interviewer not to divulge the information and use it against them. They must also feel that the interview is for a legitimate purpose.[756] Assurances of anonymity and academic credentials served this purpose.

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752 Rubin and Rubin 1995, 67.
753 Hammersley & Atkinson 1995, 83.
754 Foddy 1993, 118.
755 Rubin and Rubin 1995, 102 and 218-223.
756 Foddy 1993, 123.

Nevertheless, there is no way of guaranteeing a truthful response.[757] Finally, the interviews cannot inform us about the perspective of firms that did not invest in Russia because they were concerned about its legal environment. While this information would be useful, it is very hard to access firms while they are in the process of investing.[758]

2.7 Processing the Interviews

The research findings, presented in Chapter Four, were derived from the interviews in the following process: first, the interviews were transcribed; interview responses were grouped alongside the research question in a spreadsheet and coded according to the answer; this provided an overview of responses that facilitated the written work.

3 Investigating the Dominant Theory's Accuracy

The hypotheses and interview questions presented below are purposefully quite open ended. It appears that the Dominant Theory only presents a partial model of the relationship between foreign investors and host legal climates; it has been argued and shown that there are a number of further questions that need to be answered to develop a more accurate model. Thus our approach needs an exploratory tone. This is particularly true given the shortage of existing theory and evidence to build on. Also, this study has advocated a more nuanced, contingent approach. So, instead of arguing that a Theoretically Ideal Legal Climate is or is not necessarily required to support foreign investors, it is more appropriate to ask *when* a *particular form* (e.g. formal, informal, corrupt) of legal system might be able to support *which* type of investor, and *in what circumstances* it is not able to support them. The hypotheses and questions are crafted to enable us to arrive at such insights.

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757 Foddy 1993, 123.

758 Perry-Kessaris also draws attention to the lack of feasibility in interviewing firms during the investment process, Perry 2001, 7-8.

3.1 Hypothesis One: The Necessity of a Theoretically Ideal Legal Climate

Hypothesis One is that "a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia" The interview questions address the hypothesis by first looking at the role of law in the decision to invest, then at how foreign investors do business in the Russian legal climate.

3.1.1 The Role of Law in the Decision to Invest

One of the arguments of this thesis is that investors may not choose hosts based on accurate and detailed information about the legal climate. In fact, they may have quite a vague understanding of the host legal climate when they decide to make an investment in a particular host. Further, investors may not abandon a potential investment prospect because they perceive the absence of a Theoretically Ideal Legal Climate. The questions in this subsection are all related to these suppositions. The following question was asked in the interviews to learn about pre-investment perceptions of the Russian legal climate:

a. Do prospective and potential investors both have an accurate perception the Russia legal climate?

The terms 'prospective' and 'potential' were prompted by the pilot phase of research, when a respondent made it clear that one needs to distinguish between the business public at large, who are 'potential' investors, and the firms who have taken the extra step of investigating Russia with a view to an investment, 'prospective' investors.

The next series of questions are concerned with how foreign investors respond to more accurate information about the Russian legal climate once they have a specific investment in mind. This gets to the crux of the issue of law as a determinant of foreign investment. Through these interview questions we aim to understand the actual impact of the law on the decision to invest. Following on from the pilot phase, the following questions were devised:

b. What are the main legal issues that foreign firms need to address during the investment process?

c. What role does their perception of the legal climate play in the actual investment decision?

d. How do they respond, in their investment approach, to legal concerns?

These questions aim to move beyond existing literature, which is limited in so far as it establishes that the legal climate is a concern to investors, but then fails to describe how it actually impacts the decision to invest. To respond to the Dominant Theory and the standard research approach, we need to understand why foreign investors may not avoid states that lack a Theoretically Ideal Legal Climate. There may be several reasons for this. The Russian market may simply be too strategically vital to their business. Perhaps for some investors, the Russian legal system is above their minimum quality threshold. Or foreigners may have strategies that enable to manage the legal risks of investing in Russia, for example by deferring responsibility for legal matters a local partner. Finally, substitutes may exist for a Theoretically Ideal Legal Climate. The next subsection examines this final possibility in greater detail.

3.1.2 Foreign Investors' Activities in the Russian Legal Climate

It was argued that the Dominant Theory exaggerates the importance of a Theoretically Ideal Legal Climate in so far as it implies that there are no substitutes for a Theoretically Ideal Legal Climate in serving investors' needs. To find out whether alternatives to a Theoretically Ideal Legal Climate in fact exist, we investigate the strategies that foreign investors use in the Russian legal climate. Based on the pilot research, the following questions were posed:

e. What is meant by 'the Russian way' of doing business, and what does it imply for foreign investors?

f. To what extent are activities based on written law, as opposed to: unregulated areas; assumptions about bureaucratic behaviour; unwritten rules of behaviour; influence over the authorities?

g. Which aspects of the Russian business climate are most challenging for foreigners?

To test the hypothesis, it is necessary to learn whether foreign investors limit themselves to the formal legal system, or whether they also rely on informal practices, influence and bribery.

The questions are deliberately broad and crafted for an open, semi-structured discussion. They possess an exploratory tone because they are delving into issues that have barely been addressed in existing literature on foreign investors. Finally, in addition to testing the Dominant Theory, the questions are merited in their own right as informality and corruption are current research interests in transitional law and development.

3.2 Hypothesis Two: The Impact of Firm Characteristics on Perceptions of the Russian Legal Climate

Hypothesis Two is that "foreign investors' perceptions of the Russian legal climate depend on their firm characteristics. The impact of firm characteristics is investigated both in the context of the decision to invest and that of foreign investors' activities in the Russian legal climate. Hence, the following questions are drawn up:

h. How do the size, sector, experience and nationalities of potential and prospective investors affect their attitudes to the legal climate and their practical options?

i. To what extent does the size, sector, experience and nationality of a potential investor affect its legal and regulatory activities?

4 The Challenge of Establishing a Theoretically Ideal Legal Climate: Implications for the Dominant Theory

Research on foreign investors and the Russian legal climate is incomplete without an analysis of the challenge of the Dominant Theory's prescription for attracting foreign investment, namely, establishing a Theoretically Ideal Legal Climate. This is presented in Chapter Eight. The merit of the Dominant Theory's prescription rests on the ability of reformers to actually establish a Theoretically Ideal Legal Climate. The more distant a Theoretically Ideal Legal Climate appears to a country like Russia, the less credible a theory becomes which preaches it as the primary answer to the country's foreign investment deficit. Advocates of the Dominant Theory, however, do not take the challenges of establishing a Theoretically Ideal Legal Climate into consideration. Chapter Eight explains that establishing a Theoretically Ideal Legal Climate is a complex and long-term challenge in Russia. The sheer difficulty of establishing a Theoretically Ideal Legal Climate clearly undermines the merit of preaching it as a solution to foreign investment and further undermines the general credibility of the Dominant Theory.

Chapter Eight draws mainly from existing research. However, naturally, the opinions of interviewees about the general rule of law and reform climate in Russia were also sought. For example, they were asked:

j. Which legal developments have improved the investment climate?

k. Will current reforms substantially change the Russian legal climate, or are there more profound factors, such as the relationship between the firm/state, bureaucracy, attitudes to law, that mean that change will be limited for the foreseeable future?

The next Chapter presents the interview findings themselves.

Chapter Eight

The Impact of the Russian Legal Climate on Foreign Investors

1 Introduction

Having familiarised the reader with the characteristics of the Russian legal climate and the challenges that foreign investors can expect to face, this Chapter moves on to relate how the foreign investors and foreign investment advisors interviewed in the present study have approached and responded to the legal climate. The interviews are presented in two sections, relating to the two hypotheses:

- Hypothesis One is that "a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia."

- Hypothesis Two is that "foreign investors' perceptions of the Russian legal climate depend on their firm characteristics."

Definitions & Focus of Fieldwork

To reiterate how legal systems are being defined in this study: legal systems include both the laws and regulations according to which economic actors operate, and the manner in which these laws and regulations are applied. Thus our definition encompasses state institutions such as the judiciary, and bureaucracy, as well as politicians in their roles as law-makers and law-enforcers. Further, we are only cconcerned with laws that seek to regulate economic behaviour. This study is also interested in the role of informal institutions, which differ from formal ones by degree.[759] Informal institutions are particularly prevalent in Russia. They are important to this study because they can substitute for formal state institutions and therefore compensate for their weaknesses.

The vast majority of studies on the subject of law and foreign investment limit themselves to enumerating legal obstacles. In this study, both the general difficulties posed by the climate and their solutions are of interest. Further, both the formal legal system and the informal sphere are taken into consideration. The attitudes of foreign

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759 North 1990, 46.

investors' to central issues such as contract enforcement, the courts, corruption and the bureaucracy are examined in this study. It is left to other researchers to study attitudes towards specific bodies of law.

For the reader's convenience, the interview references include the professional background of the respondent, followed by their nationality, coded as follows:

Table 5 : Respondent's Professional Classifications

Respondent Type	*Classification*	*Count*
Foreign Investor	FDI	10
Investment Promoter	PRO	6
Lawyer	LAW	6
Finance	FIN	6
Business Associations	BUS	5
Consultants	CON	5
Government	GOV	4
Journalist	JOU	1
Non-Gov't Org	NGO	1
Academic	ACA	1

Table 6: Respondent's National and Regional Origin

National/Regional origin	*Code*	*Count*
Russia	RU	15
Britain	UK	16
North America	US	9
Western Europe	WE	3
Eastern Europe/Central Asia	EE	2

The foreign investors operated in a range of sectors: insurance, education, construction, manufacturing, retail, consumer goods, pharmaceuticals, transport and

communications. Four of the investors were small-medium sized, three were medium-large sized, and three large.

Where it is stated that respondents 'said' such and such, or that they made a particular point, this will referenced in the footnotes with citations for all the interviewees who made such a point.

2 Is a Theoretically Ideal Legal Climate Necessary to Foreign Investors?

In Chapter Four, three groups of evidence were presented to show that the Dominant Theory may overstate the importance of a Theoretically Ideal Legal Climate to foreign investors. Interview findings relating to these explanations are discussed in this Section. In subsection 2.1, the accuracy of foreign investors' pre-investment perceptions of the Russian legal climate is explored. In subsection 2.2, attention turns to the impact of the legal climate on their decision to invest, in particular, how and why foreigners may invest in spite of the perceived absence of a Theoretically Ideal Legal Climate. Finally, in subsection 2.3, we examine how foreign investors do business in the Russian legal climate. Each of the subsections demonstrates in some way that a Theoretically Ideal Legal Climate is not always necessary to support foreign investors.

2.1 The Accuracy of Pre-Investment Perceptions of the Russian Legal Climate

First, we need to distinguish between *potential* investors, that is, the broad mass of businesses for whom Russia could at some point provide an investment opportunity; and *prospective* investors, firms that are actually planning an investment in Russia. The latter's approach will be discussed in subsection 2.2

The most consistent and resounding point established in the interviews relates to the issue of foreigners' perceptions of Russia and its legal environment. There was a consensus that perceptions of Russia and its investment climate, outside the country,

are significantly inaccurate.[760] Respondents explained emphatically that perceptions are "misguided"[761], "ranging from complete ignorance"[762]. Hence it is this perception of the Russian legal climate, which can differ tremendously from the reality,[763] that informs the business community outside of Russia.

This point is borne out especially on the question of stereotypes of Russia. Russia suffers heavily from stereotyping: to many the country conjures images of Communism and the Cold War, the mafia, or more recently, football tycoons. A senior UK government official involved in investment promotion related that:

> "One company which we dealt with recently, a fairly major company, came through and said:
>
> *'I know if I present to my board and say it's country X, give the economic figures of country X, they'll say* 'well, why aren't we there?' *And as soon as you say country X is Russia, they* say 'Aah...Well, may be.'"

Another senior Briton in the Moscow investment promotion community explains that :

> "The thing that we bang our heads against is the perception itself, and that mainly comes from the media. The history of Russia as a sort of very bland and stagnant, totalitarian regime, doing what they're told when they're told. When they moved into capitalism, as it was called, in the early 90's, it became - it was just a nuclear bomb of corruption, bribes, drive-by shootings and mafia."

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760 For example, but not confined to Interviews: PRO 1 (UK), CON 2 (US), PRO 3 (UK), GOV 2 (UK), CON 3 (WE), LAW 6 (UK) & BUS 5 (UK).

761 Interview LAW 6 (UK).

762 Interview PRO 3 (UK).

763 Interview CON 3 (WE).

This stereotype includes a fear of Russia.[764] One lawyer explained how, much to his astonishment, prior to visiting Russia with a view to a possible investment, a client requested 24 hour armed security for his entire stay.[765]

It is noteworthy that these points are made by professionals, mainly investment promoters and lawyers. They are speaking, not only about the western business community in general, but about business people with whom they interact—people who are serious enough about investing in Russia that they have attended an investment conference, spoken to an investment promoter or lawyer, and have or are planning to, as the man above, visit Russia for the purposes of investment.

It is also noteworthy that potential investors have very general impressions about Russia. This means that, rather than standing out as a distinct feature, the legal system is subsumed into the overall image that investors have of the investment climate. So, from where they are standing, they see the general trends such as political risk.[766] Hence, 'big picture' changes, such as macroeconomic progress or warmer relations between Presidents Putin and Bush are important, as they cause more people to notice Russia.[767] Thus, for Russia to generate an impression amenable to foreign investment, it needs to be seen to be moving broadly in the right direction.[768] This echoes the findings of the FIAC study presented in Chapter Three.

By the same token, however, negative headlines have a strong effect on potential investors. One development that unravelled during the course of this research that produced quite calamitous headlines was the Yukos affair. This chain of events has, in the words of the interviewees, "shattered"[769] investor confidence in Russia, and the perception of predictability that was slowly building since the 1998 financial collapse of the country. Commentators argue that it has raised questions about state power,

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764 Interviews LAW 5 (US), CON 3 (WE) & LAW 6 (UK)
765 Interview LAW 5 (US).
766 Interviews GOV 2 (UK), FIN 6 (US).
767 Interview BUS 3 (US).
768 Interviews BUS 1 (RU), FIN 5 (RU).
769 Interviews PRO 4 (UK) & LAW 4 (EE).

the extent of economic freedom and the rule of law in Putin's Russia.[770] In particular, according to one interviewee, it reemphasised to foreigners the perception that Russia is still truly Soviet.[771] The Russian Finance Minister has admitted that the dismemberment of Yukos and the prosecution of Khodorkovsky has damaged the country's reputation, especially since the company and its owner symbolised to many foreign investors, rightly or wrongly, a modern Russia.[772]

The media is held partly responsible for how Russia is (mis)represented abroad. Respondents blamed the western media for highlighting only the negative developments in Russia.[773] The media was blamed for "bringing out the bad in every good situation"[774] and giving greater coverage to trivial disputes in Russia than to major deals.[775] They felt that even the more sober outlets such as The Economist, The Wall Street Journal, The BBC or CNN, which inform the western business community, had a tendency to spotlight negative stories.[776] A Moscow partner at a major international legal practice explained that he regularly met with visiting CEOs and spent much time trying to convince them that Russia "is in fact a little different than what he hears on CNN."[777] Media coverage, it was argued, had the effect of exaggerating the risks in Russia.[778] Thus, it was widely felt that Russia required a concerted image building and PR effort abroad,[779] an effort which a Russian economic minister confirmed was being undertaken.[780] Indeed, policy initiatives with

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770 Financial Times 2003.
771 Interview PRO 1 (UK).
772 The Times 2005.
773 Interviews GOV 2 (UK), LAW 6 (UK), BUS 4 (RU), BUS 5 (UK).
774 Interview BUS 5 (UK).
775 Interview LAW 6 (UK).
776 Interviews CON 2 (US) (CNN and BBC mentioned), BUS 5 (UK) (The Economist mentioned), LAW 6 (UK) (The Wall Street Journal mentioned).
777 Interview LAW 6 (UK).
778 Interviews FIN 3 (RU), LAW 4 (EE), LAW 6 (UK).
779 Interviews CON 2 (US), BUS 1 (RU) & LAW 6 (UK).
780 Interview GOV 4 (RU).

the goal of improving Russia's image abroad have frequently been the talking point in foreign investment circles, often at the initiation of President Putin.[781]

Thus bad press compounds existing stereotypes.[782] The cumulative effect of this on potential foreign investors is to prevent them from taking a deeper look at Russia.[783] This means that to some extent, potential investors are held back from researching the business case for an investment on account of their misguided general perceptions of the country. Thus the 'image barrier' is an instrumental factor in deterring FDI. In fact, one of the tasks of investment promoters is to assist prospective investors in overcoming stigmatised public impressions of Russia.[784]

It is significant that the image barrier hinders investors from further engagement, such as investigating thoroughly the opportunities and risks, and visiting the country.[785] In the terminology used in this study, the image barrier can discourage *potential* investors from becoming *prospective* investors. As an experienced British lawyer involved in investment promotion explains, transition to this latter stage of 'prospective' investor can be critical:

> "Generally we find that people who get some information, some will still say that the not-so-good bits put me off. I can honestly say that anyone who goes on a trade mission comes back saying: *'it's nothing like I thought it would be.'* Then they're hooked. Very few people come back saying: *'it's not for me.'*"[786]

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781 For further details of policy initiatives aimed at improving Russia's 'face', see Chapter Nine, Section 5.1

782 Interview GOV 2 (UK).

783 Interview PRO 4 (UK).

784 Interview PRO 3 (UK).

785 Interviews BUS 5 (UK).

786 Interview PRO 1 (UK).

In order to assert that law is a determinant of foreing investment, one must show that, when choosing the host, foreign investors refer to accurate information about the legal climate. Critically, it is evident that many potential foreign investors do not base their decision, if it can be even called one, to reject Russia on the basis of accurate and detailed information about the Russian legal system. It is not a decision as such, because inaccurate, stereotypical and sketchy impressions of Russia, according to the interviewees, act as an immediate deterrent to foreign investors into Russia, preventing them from actually looking at the country, its opportunities and risks in greater depth. Further, perceptions of the legal climate are not discernable from the blur of sweeping and often misguided overall impressions of the country and political risk there.

These conclusions are supported by some of the literature presented in Chapter Four.[787] Within the FDI literature, both Perry-Kessaris and Hewko strongly question the importance of legal systems to FDI choices. The findings also corroborate the literature on behavioural decision making. For instance, media coverage of Russia is distorting, giving rise to an situation in which, "people are likely to think, mistakenly, that salient events are more common than equally prevalent but more subtle ones."[788] In this way negative headlines generated, for example by the Yukos affair, or the shooting of a prominent journalist, will have a greater impact on investors' perceptions than gradual improvements caused by the country's recent administrative and regulatory reforms. Bounded rationality also asserts that we use rules of thumb in our decisions: observing the quality of relations between heads of states would seem to fit this category. The point that newsworthy events have an appreciable impact of foreign investors was made in the analysis of the survey conducted by the Foreign Investment Advisory Council of Russia. The FIAC study seemed to show that the appearance of steps being made in the right direction

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787 Chapter Four, Section 2.

788 Jolls *et al.* 2000, 50-51.

matter more to investors than the current quality of the legal climate.[789] Finally, the findings reassert the point that the image of Russia abroad is a pressing foreign investment issue.

2.2 The Impact of Law on the Investment Decision

The interviewees pointed out that one must distinguish between so-called 'potential' investors and 'prospective' investors. The previous subsection examined the perceptions of potential investors, those who are at the preliminary stage of an merely contemplating Russia as a possible investment destination. This subsection turns to the impact of the legal climate on prospective investors, those who are considering a specific investment opportunity. The interviews showed that to judge how important a Theoretically Ideal Legal Climate is to investors, it is necessary to first understand at what point 'the law' actually becomes a factor in the decision to invest in Russia; and then, what effect it has on the decision.

The Russian legal climate becomes a salient issue once a firm has become a prospective investor, that is, once they are involved in a process of planning an investment. According to the interviewees, the first step in the investment decision process is establishing the 'business case' for an investment.[790] Critically, legal analysis follows if and when a business case has been established, and a decision, in principle, has been taken to invest.[791] As a lawyer explained:

> "I think it's a question of timing. By the time they come here and start talking, and are paying overpaid legal counsel to give them advice, they've already crossed that hurdle of : *'will we do this or not, do we want to do this or not?'*"[792]

It is logical that analysis of the relevant laws and legal institutions would come after the business opportunities have has been considered. First, the business case is paramount, without a tangible investment opportunity, legal analysis is redundant.

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789 Chapter Three, Section 2.
790 Interview PRO 4 (UK).
791 Interview PRO 4 (UK).
792 Interview LAW 5 (US).

Second, legal consultation imposes transaction costs in terms of lawyers' fees and investors' time; this is why the market decision, in principle, should precede the legal investigation. Finally, legal consultation is only effective once the details of an investment have emerged. For example, due diligence is conducted once a potential partner has been identified. [793]

The next question is: how do investors react to information about the legal climate? Do they abandon a potential investment because they perceive the legal climate as theoretically weak? One lawyer couldn't recall a single investor who had abandoned a "solid business case" because of what they were told about the Russian legal climate.[794] A risk advisor said that clients "very rarely" walk away from Russia as a result of the advisor's work.[795] These responses may be tainted by the hubris of the advisors. On the other hand, the findings presented in the previous subsection suggest that investors might even be relieved by what their advisors tell them about the legal climate, given their initially exaggerated concerns. Indeed one respondent made a similar point, arguing that prospective investors are not turned off by the legal climate because they come in knowing that the legal system is poor.[796]

It is fair to assume that whatever concerns are raised during the legal consultation process, lawyers would strive to offer adequate solutions. While risks cannot be eliminated, they can be dealt with. One lawyer advises that the risks "are not as great as you might otherwise think, they're more manageable than you might otherwise think, here's what you can do to manage those risks."[797]

The existence of legal challenges does not mean that foreign firms will abandon Russia. They can respond to the challenges, legal or otherwise, of operating in Russia via the timing of their approach and their market entry strategy. For example, they

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793 Interview CON 1 (RU).
794 Interview LAW 5 (US), LAW 6 (UK).
795 Interview CON 1 (RU).
796 Interview LAW 2 (US).
797 Interview LAW 6 (UK).

may defer the decision, whilst not abandoning Russia altogether.[798] Or they may spend longer researching and entering. For example, a major British industrial investor related that his firm spent two years considering an acquisition, before deciding to enter the market greenfield.[799]

Gradual approaches to entering Russia may be available to some potential investors. Investors who are looking to sell their products on the Russian market, but are unsure about the opportunities or challenges may open a 'representative office.'[800] This is a relatively cheap and low exposure method of entering into Russia. Over a period of time, the foreign firm starts to trade and is in a better position to decide whether the opportunities and risks support an investment. A lawyer with 15 years experience in Moscow stated that many firms may not get beyond this first step, but very few leave altogether.[801]

A well established means of alleviating legal challenges is to take a Russian partner and to employ local staff, especially accountants and lawyers. In this way the incoming investor can pass on responsibility for dealing with issues that they find more difficult, whether they relate to legal or business operations. For example, Russian lawyers and accountants are useful for their familiarity with local bureaucratic processes, such as tax or licensing regulations, and the contacts they have in government agencies.[802] Perry-Kessaris found the same principle in action among foreign investors in India.[803]

By using various techniques to enter the market, foreign investors aim to attain a level of comfort regarding the risks involved. As risk contains a strong element of perception,[804] the decision may turn on what level risk the individual decision

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798 Interview BUS 1 (RU).
799 Interview FDI 2 (UK).
800 Interview CON 2 (US).
801 Interview LAW 6 (UK).
802 Interview PRO 1 (UK).
803 Perry-Kessaris 2005, 176.
804 Interview CON 1 (RU).

makers are comfortable with. What is good enough for one investor may not be good enough for another in a similar situation. Hence, as argued in Chapter Four, much depends on the investor in question.[805]

Conclusions

To assess the alleged necessity of a Theoretically Ideal Legal Climate, one must examine as closely as possible the impact of the law on the decision to invest. The role of the legal climate in the investment decision is quite nuanced. First of all, investors only examine the legal climate thoroughly after the decision, in principle, has already been made to invest. This implies that investors choose between hosts on the basis of the strength of the business opportunity, not according to whether the host legal climate resembles the theoretical ideal. Further, it is rare, according to these interviewees, that investors abandon an opportunity because of what they learn about the legal climate or the legal advice given. Instead, investors can adapt their approach in order to be comfortable with the risks that they perceive. Thus, the issue of the legal climate is neither paramount in the minds of investors, nor is its impact absolute. Rather, legal issues can be secondary; investors have flexibility in their approach to the legal climate; and the impact of the climate is 'subjective' - it will depend on the investor in question.[806]

It could be argued that the legal climate deters potential and prospective investors at three stages. First, when the legal climate forms part of potential investors' overall perceptions of Russia, for instance, of political risk there. Second, as investors gain familiarity with the business environment and are establishing the business case, they will become informed, accurately or inaccurately, from various sources about the legal environment in Russia; what they learn may deter them from pursuing the opportunity further. The final point at which the legal climate may deter the

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805 See Chapter Four, Section 4.

806 Further evidence of 'subjectivity' will be presented in the context of the second hypothesis, in Section 3.

prospective foreign investor is when they seek legal advice in the run-up to embarking on a specific project.

The evidence here suggests that inaccurate and stereotypical perceptions of Russia in general have a strong deterrent effect on potential investors, preventing many of them from actually examining the opportunities and risks of Russia and then arriving at a decision. Thus the quality of the legal climate is an important determinant of foreign investment to the extent that elements of the legal climate contribute to this negative general impression. There is little evidence to confirm or refute the supposition that potential foreign investors are put off by what they learn about the legal climate during the later, investigation stage, when information becomes more accurate. Unfortunately, methodological constraints make it hard to measure accurately which foreign investors 'ran away' from Russia. Based on the interviews, it is suggested that information about Russia, especially about the opportunities there, has a positive effect on investors. For example, a leading British lawyer/investment promoter states that *"the first step, then, is getting them informed. And the second is getting them into Russia, once they're in, they're pretty much sold."*[807] This is consistent with the point that initial concerns about Russia are generally exaggerated. Finally, the evidence here refutes the claim that in-depth legal advice given to prospective investors changes their minds about a planned investment.

There is little evidence in this subsection to persuade us that a Theoretically Ideal Legal Climate is 'necessary' to attract foreign investors to Russia. Based on the opinions of the interviewees, it appears that foreign investors do not choose the host on the basis of its quality of its legal climate; nor, in turn, do they abandon an investment prospect because they perceive the absence of a Theoretically Ideal Legal Climate. The finding is consistent with a number of points made by previous research and outlined in Chapter Four.

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807 Interview PRO 1 (UK). This is supported by the UK government official who says "It's surprising how many people come in and say, *'it's not what I expected, it's far more like a western market.'*" Interview GOV 2 (UK).

Three studies presented in Chapter Three demonstrate that foreigners may not be dissuaded from investing, even though they acknowledge the shortcomings of its legal climate. For instance, Perry-Kessaris finds that foreign investors' assessments of the Sri Lankan legal climate class it as a theoretically unattractive (inefficient and unpredictable) one. Nevertheless, 83% would still have invested there if they had known prior to investing what they learned during operations about the Sri Lankan legal system. Elteto and Sass study foreign investors in Hungary. Their study shows that the Hungarian legal climate was a "very important" motive for foreign investors, but at the same time they labelled it as "inadequate,"[808] which begs the question of why foreigners invest nonetheless. Similarly, the 2005 FIAC study of foreign investors in Russia was also remarkable for its contrasting findings: while the legal and regulatory climate stood out as the most significant obstacle to business, and appeared overwhelming, the vast majority of current investors were planning on increasing their investments, while most potential investors had plans to invest in Russia.[809]

The findings here show that foreigners may invest in spite of the legal climate if their motivation for investing overshadows the deterrent effect of the legal climate. Further, the findings demonstrate various ways in which legal risks can be managed. This corroborates existing literature, which demonstrates that risks can be mitigated by outsourcing legal responsibilities to joint venture partners[810] and locals.[811] Unfortunately, the Dominant Theory does not take into account these important aspects. The final reason why the absence of a Theoretically Ideal Legal Climate may not prevent foreigners from investing is that a non Theoretically Ideal Legal Climate can still support foreign investors. The next subsection explores this possibility.

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808 Elteto & Sass 1998, 10-11.

809 See Chapter Three, Section 2.

810 Chapter Four, Section 4.2.1. See, for example: Lankes & Venables 1997, 560; Perry 2001, 93; Thornton & Mikheeva 1997, 105.

811 Perry-Kessaris 2005, 176.

2.3 Doing Business in the Russian Legal Climate

In this subsection we continue to consider why a Theoretically Ideal Legal Climate may not always be necessary to support foreign investors in Russia. However, the discussion now proceeds from the role of law in the investment decision to foreign investors' engagement with the legal climate, once they have actually invested in the country. Is the Dominant Theory justified in asserting that a Theoretically Ideal Legal Climate is required to support foreign investors? Or can foreign investors can get by in Russia's non-theoretically ideal legal environment?

This subsection is also relevant outside of the ambit of the hypothesis.[812] It provides something there is scarcely any of in the literature - a detailed and first hand account of how foreign investors actually engage with and cope in the Russian legal climate. This is remarkable given the amount of literature devoted to listing the obstacles in its legal climate. It is particularly important because, as Chapter Eight shows, a Theoretically Ideal Legal Climate may take a very long time to establish in Russia. Finally, this subsection extends topical issues in transitional law and development, such as the role of corruption, influence and informal institutions to the study of foreign investors.

Both the assessments of the Russian legal climate in Chapter Five and the interview findings make it clear that the Russian legal climate does not resemble the Theoretical Ideal. The interviews support Hypothesis One, ("a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia") in so far as they demonstrate that foreign investors can operate successfully in spite of this. The subsections that follow look in greater depth at how foreigners adapt to the Russian legal climate. The interviews show that a twin approach is required to effectively interact in the Russian legal climate. Foreign investors need to engage fully in the formal legal system, but at the same time support that approach with a strategy that takes advantage of the informal practices that are pervasive in the

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812 Hypothesis One is that "a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia."

environment. What this means is that it appears that while a polished formal legal climate may well be desirable, it may not be a precondition to attracting investment. The reason being that foreign investors can be pragmatic and adapt to the climate, protecting their rights by resorting to informal practices, influence and bribery where the official legal system is inadequate.

Four legal spheres were highlighted in the interviews as being of concern to foreign investors: the bureaucratic environment, contracting and disputes, due diligence, and to a lesser extent, intellectual property rights.

2.3.1 Bureaucracy

In Chapter Five, it was shown that according to the BEEPS survey and other assessments, the most troubling aspects of the legal climate for domestic and foreign firms were the bureaucracy and bureaucratic interference. The interviewees reiterated the point that the biggest operational problem for foreign investors in Russia is the bureaucracy.[813] First of all, "Russia is a great country for rubber stamps"[814] - bureaucracy is pervasive and extensive. Second, laws and regulations are often senseless, vague, contradictory and overly demanding.[815] Third, bureaucrats have too much discretion in applying the rules,[816] which inevitably fosters corruption and causes unpredictability.

Informal, personalised approaches substitute for formal and impersonal bureaucratic procedures, and serve as solutions to problems stemming from the bureaucratic environment. Depending on the particular situation encountered, a foreign investor's interface with the bureaucracy can take three forms: they can either engage directly with government officials; employ intermediary agencies; or have recourse to a

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813 For example, interviewees who explicitly made this point: PRO 2 (UK), FIN 3 (RU), FDI 1 (UK), CON 4 (RU).

814 Interview GOV 2 (UK).

815 Interviews FDI 1 (UK), FDI 4 (WE), CON 5 (US), LAW 4 (EE).

816 Interviews LAW 4 (EE), CON 5 (US), LAW 6 (UK).

security structure or 'krysha'. In so far as these suffice for foreign investors, a Theoretically Ideal Legal Climate may not always be necessary to support them.

A central part of business operations in Russia revolves around acquiring permissions to conduct the chosen activity. Acquiring operating licences, permits, approvals and permissions in Russia is a highly bureaucratic process. However detailed the requirements, obtaining most licences is ultimately a question of the firm's relationship with the issuing agency.[817] So, part of their legal strategy must be to cultivate relationships with government officials.[818]

Foreign investors therefore survive in Russia by engaging the authorities positively, in order to prove their fitness for the licence in question; bribery is not necessarily required,[819] although much will depend on the regulatory sphere and regulators in question.[820] Fostering friendly relations[821] and establishing goodwill by seeking the advice of officials,[822] inviting them to the premises and gift-giving[823] or paying a bribe[824] were considered to be useful strategies in licensing. In cases where obtaining permissions does not depend on an official's judgment, that is, where all applicants will receive the permit, but the length of the process is a hindrance, bribes are useful for expediting applications.[825]

The development of cordial relations with the bureaucracy is best outsourced to locals. Foreigners themselves, according to a leading British investment promoter, cannot engage effectively with the lower levels of Russian bureaucracy,[826] whereas a

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817 Interview LAW 5 (US).
818 Interview FDI 8 (EE), LAW 5 (US), LAW 6 (UK), CON 5 (US).
819 Interview LAW 5 (US).
820 Interview LAW 4 (EE), LAW 5 (US), CON 4 (RU).
821 Interview LAW 5 (US), CON 5 (US).
822 Interview LAW 5 (US).
823 Interview PRO 4 (UK), BUS 5 (UK).
824 Interview LAW 2 (US), CON 5 (US).
825 Interview LAW 2 (US).
826 Interview PRO 1 (UK).

Russian manager can.[827] One European Chamber of Commerce tells its members to not engage in bribery, but to leave it to Russians.[828] Thus, part of the adaptation strategy of foreign investors is to 'go native' by means of well-connected Russian employees,[829] lawyers,[830] or partners[831] who will administer day-to-day legal and bureaucratic matters.

In some regulatory spheres, specialist agencies are hired to obtain the requisite approvals. These private agencies have close ties with the regulating government agency, for example, they may be run by former government officials or members of the security services. Respondents used these agencies for telecommunications licensing,[832] insurance[833] and the visas of foreign staff.[834] Foreign investors can also use these agencies to purchase 'off-the-shelf' companies that have already acquired the registrations and permissions needed to start operating in a given sector.[835] Customs is a sphere in which such agencies are particularly active.[836]

The third and final part of a foreign investor's legal strategy is having a *krysha* (roof):

> "So, you have to understand and obey the law, but beyond that, there is also a practical way that things are done. For example, there may be no laws with regards to certain business activities, but it should be a well understood fact that before you engage in this activity, you find out who the competition is, how strong they are, meaning – not what is their market share, and what their management systems are, but who is their krysha? Who is sponsoring them and how much influence do they have?"[837]

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827 Interview CON 5 (US).
828 Interview BUS 2 (WE).
829 Interviews LAW 4 (EE), CON 3 (WE).
830 Interviews PRO 3 (UK), FDI 7 (UK).
831 Interviews PRO 1 (UK), PRO 3 (UK).
832 Interview FDI 9 (UK).
833 Interview FDI 10 (UK).
834 Interview FDI 4 (WE).
835 Interview FDI 7 (UK).
836 Interviews FDI 3 (UK), BUS 2 (WE). See also Remmes 2002, 4.
837 Interview CON 5 (US).

A krysha is a connection to a person with influence who can protect the client's interests. The krysha is usually either a politician or a contact within influential government ministries such as the state security services.[838] The krysha could also be within the 'mafia' or a private security firm, though there was bare mention of this in this research.[839] Influential ties are important both in assessing one's competition, as the previous quote indicated, but also in more routine legal operations. For example, one foreign investor described how their firm's 'security structure' worked to both pre-empt and respond to legal problems arising from government officials:

> "In our case we have a security division within the company, and it's linked to one of the government agencies, and if there's ever a problem, our people call our contacts, and they make sure that the problems are limited or solved. We have an ex-MVD [Ministry of Internal Affairs] guy, and it just depends which organ within the government you want to have your assistance from. They help you with all sorts of issues – one of your employees is in a car accident, or you run someone over, or you have a fire inspection, or one of your employees has stolen something – from the little problems, to full blown tax inspections."[840]

A point made by two respondents offer a final insight into the dynamic of the bureaucratic environment and the extent to which good connections are effective. One investor explained that, owing to the firm's 'security structure', bureaucrats "can't come up with hot air, there has to be a very specific situation."[841] Similarly, an American lawyer remarked that:

> "You cannot cause me problems in the 64th militia, unless I've really done something wrong, because their attitude is: *'we know those boys, one of our guys took some money from those boys, he was fired without a pension, so if it doesn't look real we're just not going to touch* [sic].'"[842]

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838 Interview LAW 4 (EE), LAW 6 (UK), CON 5 (US).
839 One Russian in corporate finance suggested this, Interview PRO 6 (RU).
840 Interview FDI 6 (UK).
841 Interview FDI 6 (UK).
842 Interview LAW 2 (US).

In conclusion then, while good contacts will act as a buffer against groundless harassment, they do not provide foreign investors with a *carte blanche* to violate laws. A final caveat, however, is that while informal practices are not guaranteed to prevail over the application of rules and regulations, "in ten years here, I haven't yet come across one problem that can't be resolved with money."[843]

2.3.2 Contracting and Disputes

Naturally, property rights protection is a key concern of economic actors in weak legal environments. As demonstrated by the BEEPS and other assessments in the previous Chapter, one of the weak links of the Russian legal system is the application and enforcement of laws by the courts.[844] As we will see, this can be due to three factors: the role of politics and influence; bribery; ineffective enforcement of judgements. The interviews show that foreign investors use a combination of formal and informal legal measures in order to reduce contractual risks and deal with disputes. Formal measures are common in contracting and structuring relations, while recourse to informal measures are often called for in disputes and the enforcement of property rights.

It has already been demonstrated that the recommended legal strategy for foreign investors is to adopt the practices that are suited to Russia. In contracting, this principle remains true. Legal strategies can be used to minimise the risks of investing. For example, foreigners can manage contractual risks by taking advance payment; by making the standard terms and conditions of a contract governable by Russian law (instead of foreign law); and by using a contractual format that a Russian court will be familiar with.[845]

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843 Interview FDI 1 (UK). Interviewee FDI 6 (UK) made a similar point, that "everything can be negotiated."

844 Chapter Six, subsection 2.2.

845 Interview LAW 6 (UK).

To maximise their chances of prevailing in a dispute it is important that foreign investors structure their relationships with detailed agreements.[846] Risks can be mitigated via the contractual provisions. For example, undesirable shareholders can be 'ring-fenced', stronger assurances for repayment of the investment by the Russian partner can be asserted, or provisions can be included to separate the new company from the Russian partner's existing businesses.[847]

Foreign investors are perceived to have a poor success rate in legal disputes with local businesses such as their joint venture partners,[848] and there is a perception that Russian courts are biased against foreigners.[849] This track record has improved of late,[850] especially in Moscow.[851] One lawyer laid out the set of circumstances in which recourse to the courts might be effective:

> "So, my feeling in a nutshell about Russian law is that if politics is not involved and the other side is not bribing, the system works. If it's you against the government, and politics are not involved, the system also works. For example, if you receive good tax advice, and you've implemented it well, you have an extremely high chance that you're going to win.
>
> If politics are involved, all bets are off. And the higher the politician involved, the less chance you're going to win. Nobody wins against President Putin, and nobody wins against [Moscow's] Mayor Luzhkov, and it doesn't really matter what the law says. And when you're in the regions, it's about the same with the regional governors."[852]

According to the formula above, the decisive question in a legal dispute is, 'who is the opposition', or, in the words of an interviewee already quoted, *"who is their*

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846 Interview PRO 6 (RU).

847 Interview CON 1 (RU).

848 See, for example, Interview LAW 3 (UK), LAW 6 (UK), Black & Tarassova 2002, 15; Dean 2002, Hertzfeld 2000, 4; however, the only piece of research that surveys the success of foreign litigants, concludes that "the likelihood of a foreign party obtaining a fair outcome in the Russian court system is greater than generally believed", Hendrix 2001, 112.

849 Hendrix 2001, 94.

850 Interviews CON 1 (RU), LAW 3 (UK), PRO 4 (UK) & LAW 6 (UK).

851 Interviews CON 1 (RU), PRO 1 (UK).

852 Interview LAW 2 (US).

krysha? Who is sponsoring them and how much influence do they have?"[853] Thus, when politics and influence are involved, the independence of the judiciary is swayed by the relative degrees of influence the rival parties can militate in their favour. Ledeneva also argues that resolving problems in Russia hinges on the power of the network that one can mobilise.[854]

Where politics are not involved, that is, when one party is not relying on an influential ally to interfere in the case, the playing field may still not be level, due to straight bribery. Opinions varied on the degree of corruption of the courts and the impact this has on foreign investors. Some felt that the entire system is corrupt,[855] but more felt that the courts had improved notably.[856] One lawyer felt that corruption only affects a minority of disputes,[857] another held that it was now the norm to go to the courts.[858] Other respondents took the position that the courts should be avoided.[859]

The operative principle in judicial corruption is that the first party to pay the court, wins.[860] What was thought to be the implication of judicial corruption on foreign investors? On the one hand, some respondents argued that foreign investors could not engage in the foul play that can be entailed in disputes;[861] in contrast, others noted that recruitment of Russian counsel by foreign investors is a euphemism for

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853 Interview CON 5 (US).

854 Ledeneva 2001, 30.

855 Interviews FIN 2 (US), LAW 2 (US).

856 Interviews PRO 1 (UK), GOV 2 (UK), LAW 3 (UK), LAW 6 (UK) & BUS 5 (UK).

857 Interview LAW 3 (UK).

858 Interview LAW 6 (UK).

859 Interviews LAW 4 (EE), BUS 5 (UK).

860 Interview LAW 2 (US). The following joke was recounted a number of times by the interviewees, albeit with different protagonists and sums of money involved: Abramovich and Khodorkovsky are suing each other. Abramovich offers $1m to the judge, while Khodorkovsky offers $1.5m. So the judge, in a dilemma, seeks the advice of his colleagues. 'What shall we do?' he asks, to which, one of his colleagues replies: 'Why don't you get another half a million from Abramovich, and then we can try the case on its merits!'

861 Interview LAW 4 (EE). 'Foul play' is not limited to bribing the courts, but prompting various government agencies to investigate the opposing party and support false charges against them. Interviews LAW 2 (US), CON 5 (US).

bribing the courts.[862] Therefore, it again depends on the attitudes and circumstances of the investor.

The final reason why Russia's legal climate is described as weak and unpredictable is due to the often arbitrary and inconsistent enforcement of court judgements.[863] The example of intellectual property protection will be used to demonstrate how foreign investors must, again, rely on a combination of formal and informal procedures. First of all, foreign investors must register their brands with the various government bodies, such as *Rospatent*, which administer IP matters. In the case of a violation, foreign investors should bring evidence to them.[864] According to a senior official at a European Chamber of Commerce, most disputes are settled out of court.[865] Whether the matter goes to court or not, foreign investors can come up against a lack of will and motivation, so it is necessary to motivate enforcement agencies.[866] Thus, foreign investors need to pay law enforcers to pursue the violators.[867]

There is evidence in the literature that firms in Russia, owing to the weakness of the judicial system, rely more than usual on dispute resolution outside of the courts.[868] Similarly, in the present study, one interviewee explained that Russian businessmen may sign detailed agreements between themselves, in plain 'non-legal' language, and then, in the case of a dispute, take these to a structure that "has real power", such as the mafia or security services.[869] Foreign investors do indeed use private arbitration and other forms of out of court settlement, however, there is insufficient evidence to indicate the relative extent of reliance upon state and non-state dispute resolution approaches.

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862 Interview LAW 2 (US).

863 See, for example, Levin & Satarov 2000, 6-7; OECD 2001, 16-17; Economist Intelligence Unit 2003; Berglof *et al.* 2003, 72, 80-84. This point is discussed in greater detail in Chapter Six, Section 4, and also Chapter Two, Section 3.3; the point is verified by the fieldwork, for example Interviews LAW 6 (UK), BUS 3 (US).

864 Interview CON 5 (US), BUS 5 (UK).

865 Interview BUS 5 (UK).

866 nterview CON 5 (US).

867 Interview CON 1 (RU).

868 Hendley *et al.* 1997, 2000.

869 Interview PRO 6 (RU).

As with any jurisdiction, in Russia it is preferable to settle out of court, where possible.[870] In order to circumvent the Russian courts, foreign investors often specify foreign courts or arbitration venues in their agreements; in fact, one European Chamber of Commerce was at the time attempting to set up an international arbitration forum.[871] However, the enforcement of foreign court judgements in Russia still faces signicant difficulties.[872] Instead disputes can often be successfully arbitrated through the local Chambers of Commerce.[873] Also, tax disputes can often be settled through negotiation with the tax authorities.[874] Finally, as one might expect, smaller businesses cannot afford the legal costs of going to court, and therefore rely more heavily on personal relations and private arbitration.[875]

2.3.3 Due Diligence

Prior to entering into a substantial business relationship, for example with a joint venture partner or a key supplier, foreign investors will have to undertake due diligence. Lack of information about one's rights and the absence of clear rights can increase costs to investors. This is indeed a problem, given the lack of transparency in Russian business.[876] Thus formal due diligence can be insufficient. To compensate for this, foreign investors must also take account of various 'grey' issues in order to accurately assess the risk of a partnership. One practitioner explains:

> "Due diligence from a legal standpoint is to make sure all the i's have been dotted, the t's crossed, everything was done legally, legitimately; from an accounting standpoint it's to go over the books. What I try to do is find that second set of books, to find out if the numbers are actually real. Look at those so-called debtors – who are they really? I don't know how many times I've found companies whose distributors

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870 Interviews PRO 1 (UK), LAW 4 (EE).
871 Interview BUS 5 (UK).
872 Remmes 2002, 6; OECD 2001, 18; Hertzfeld 2000, 4-5.
873 Interview PRO 1 (UK).
874 Interview CON 4 (RU).
875 Interview CON 3 (WE).
876 Chapter Two, subsection 2.2.1.

owe them money, and in reality they're owned by friends or relatives of the directors...

What I do is find out who really controls this company that you're about to invest in. What are their spheres of influence, political and criminal? Are they paying their customs duties, are they doing something to tilt the market in their favour? Some companies are wise enough to see areas that require investigation, law firms definitely wouldn't."[877]

It appears then, that for firms to succeed in the Russian legal climate, they must be prepared to investigate and tackle some slightly opaque issues. One of the keys to coping in the Russian legal climate is a readiness seek solutions that lie a step beyond the traditional boundaries of formal legal systems, though are not necessarily in unethical or illegal territories.

2.3.4 Conclusions

The findings clearly show that, to be successful, foreign investors must adapt their legal strategies to the Russian legal climate. They need, therefore, to invoke a blend of formal procedures and informal practices, sometimes in combination. The extent of their reliance on one or the other depends on the legal sphere in question and their own attitudes. Respondents all made the point that foreign investors must abide by the law, and be as thorough as possible, not so much for reasons of principle, but because Russia has a "very unforgiving legal climate."[878] Failure to follow regulations carefully and employ legal prudence will provide regulators and competitors with ammunition to cause problems.[879] Legal diligence must also be supplemented with informal practices, such as making use of influential connections and contacts with government officials, paying-off bureaucrats and law-enforcers, often for legitimate ends, such as speeding up licensing applications or enforcing court judgements. Foreigners do not need to get their 'hands dirty' with such practices, but can leave

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877 Interview CON 5 (US).
878 Interview LAW 5 (US).
879 Interviews LAW 5 (US), CON 5 (US).

these to local staff and partners, who will be more adept at navigating the Russian legal system.

The interviews support Hypothesis One to the extent that they demonstrate how foreign investors can be supported by a weak legal climate. For instance, as expected, informal practices and bribery compensate, to some extent, for the shortcomings of the formal legal system. This shows that a Theoretically Ideal Legal Climate is not as 'necessary' as the Dominant Theory alleges. Here we must highlight the distinction between a Theoretically Ideal Legal Climate and a workable one: while foreign investors should not predicate their business plans on being able to obtain effective redress from the legal system,[880] the legal system is 'do-able'.[881] So, the host legal climate, while far from the Theoretical Ideal, may still be *satisfactory* in the eyes of certain foreign investors; Perry-Kessaris also suggests this explanation in her study of foreign investors in Sri Lanka.[882]

The second crucial finding is that much of the impact of the legal climate depends on the investor and investment in question. Section 3 looks at this question in more depth, showing how the legal strategies of foreign investors depend on their characteristics.

2.4 Conclusions: Assessing the Necessity of a Theoretically Ideal Legal Climate

Hypothesis One is that a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia. The interviews supported this hypothesis in three ways.

First, during the preliminary stages leading up to an investment, the interviews showed that investors do not even look at the legal climate carefully. Many potential foreign investors, do not consider investing in Russia, not because they have

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880 Interviews CON 2 (US), BUS 3 (US).

881 Interviews PRO 3 (UK), LAW 4 (EE), CON 3 (WE) & LAW 6 (UK).

882 Perry 2001, 125-126.

examined the legal climate closely, but on account of the inaccurate and stereotypical impressions of Russia that they have. In the words of a British investment promoter:

> "British companies fall along a continuum, in terms of their attitude to Russia. Predominantly, complete ignorance and lack of interest, and that would apply to a very large proportion of British companies. It simply hasn't got on the radar."[883]

Sketchy impressions, which often derive from the media, deter them from looking at Russia' investment opportunities and legal risks at greater depth. Further, when potential investors look at Russia from afar, the legal climate does not stand out, but is subsumed within the blur of sweeping and often misguided overall impressions of the country and political risk there. At this stage, what Russia as a country requires is a generally more positive image abroad, rather than specific improvements in its legal climate, which may go unnoticed. As mentioned elsewhere, the Russian government has acknowledged the need to improve Russia's image abroad.[884]

Second, the interviews suggest that investors neither choose nor reject Russia on the basis of their assessment of its legal climate. The business opportunity is the most decisive factor, and legal assessments are only conducted once a decision has been taken, in principle, to invest. The interviews suggest that investors rarely abandon a potential investment after examining the legal climate. Instead, investors can adapt their approach to the legal challenges in order to manage the risks they perceive, for example by recruiting local staff and partners. Thus, not only are legal issues secondary to the investment decision, but legal challenges can be responded to, and how this is done depends on the investor.

Finally, just as the legal risks of investing in Russia can be managed, so too can the legal challenges of operating in the country, even if they appear daunting at first. As one might expect, informal procedures are relied upon to compensate for the

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883 PRO 3 (UK).

884 Chapter Four, subection 2.2.

shortcomings of the formal legal system. According to the advocates of the Dominant Theory, an ideal legal climate is one with impersonal and automated regulatory procedures. Without a transparent framework in place in Russia at present, foreign investors can instead take advantage of the discretion available to government officials. To secure their rights, they need to foster good relations with bureaucrats, which may involve giving them gifts. Investors may also influence government officials and the courts either by way of bribes, or via personal connections.

The findings do not completely refute the Dominant Theory, nor was the intention such. There is no suggestion that foreign investors would not welcome significant improvements in the legal climate, nor administrative and judicial improvements would not eventually contribute to greater investment in the future. But it would be a mistake to view the issue as black and white when it evidently contains numerous shades of grey. The interviews verify the hypothesis that a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia, in two ways: first, the legal climate is not a paramount factor in the decision to invest; second, legal obstacles do not have the detrimental impact that the Dominant Theory predicts. We can conclude then, that the Dominant Theory only provides a partial explanation of the relationship between foreign investors and the Russian legal climate, and in doing so tends to exaggerate the importance of a Theoretically Ideal Legal Climate. One way to interpret this finding is to read it as showing that there this a faction of foreign investors who do not conform to the Dominant Theory. The next Section extends this approach.

3 Are All Foreign Investors The Same?

The second Hypothesis is that foreign investors' perceptions of the Russian legal climate depend on their firm characteristics. In this Section we examine how the impact of the Russian legal climate, both in the decision to invest, and during operations, depends on the attributes of foreign investors. Investigation of this issue has two merits: first, it enables one to discern whether a Theoretically Ideal Legal Climate is of equal importance to all investors, or whether it depends on particular characteristics; second, the role of firm characteristics merit research in their own right, as they provide a more sophisticated understanding of foreign investors and the law. The interviews touched on a number of firm characteristics, for instance, size, nationality, firm sector and experience.

3.1 Size

3.1.1 Differences Between Small and Large Foreign Investors

According to the interviewees, the firm attribute with the greatest impact on a firm's approach to the legal climate in Russia is its size. A foreign investors' size can affect their perceptions of law in the decision to invest. For example, small firms are more swayed by headlines and bad press, while larger firms can afford to conduct more thorough research,[885] and hire the best legal counsel.[886] Thus, while smaller firms may be put-off by their poor general perceptions and therefore not go on to assess the business climate any further, bigger firms can afford to both investigate the opportunities and risks more extensively, and also to persevere in spite of the legal challenges. Another implication of size is that, the bigger the firm, the more attention will be paid to the formal aspects of the legal climate.[887] Finally, larger western investors into Russia attract attention, and so their entry is loaded with a political and public relations dimension. For example, one British investor interviewed was

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885 Interviews PRO 1 (UK), PRO 4 (UK) & BUS 2 (WE).
886 Interview PRO 2 (UK).
887 Interviews PRO 4 (UK), PRO 6 (RU).

personally assisted during the investment process by both the UK Ambassador to Russia and the Russian Minister for Economic Development.[888]

Firm size also has a great impact on foreign investors' standing once they are operating in Russia. According to existing literature, the general principle by which small and large firms differ, and are advantaged or hamstrung is this: small firms are less visible and are therefore able to evade the formal legal and tax system to an extent, whereas larger firms are more visible, but at the same time have greater clout.[889] The interviews verified these points.

The extent of regulations in Russia, the start-up costs for business and the level of taxation together shape the strategies of small firms, including foreign investors. This overall burden has a bigger impact on small businesses, as they have fewer resources to deal with the financial and time transaction costs. As a consequence, operating legally can be "the least efficient way to go."[890] So, in order to maximise efficiency,[891] firms need to go 'underground'[892] meaning to avoid officialdom and the taxman as much as possible.[893] In fact, one western consultant in Moscow advises foreign start-ups to do precisely that.[894]

As already mentioned, one aspect of the regulatory environment that is particularly unwelcome is bureaucratic interference. Bureaucratic interference is somewhat correlated to the visibility of a firm, for example, a retailer will suffer more bureaucratic intrusion than a wholesaler, as in the case of one of the respondents.[895] Small firms are less prominent, and thus are less at risk of attracting attention from

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888 Interview FDI 2 (UK).
889 Hewko 2002, 10; Perry 2001, 148-151.
890 Interview FDI 7 (UK).
891 Interviews FDI 6 (UK), FDI 7 (UK).
892 Interview CON 2 (US).
893 Interview FDI 1 (UK), CON 2 (US), FDI 6 (UK) & FDI 7 (UK).
894 Interview CON 2 (US).
895 Interview FDI 1 (UK).

predatory bureaucrats. Moreover, it is less risky for them to bribe officials.[896] Small firms also reported using 'fixers' to procure licences.[897] Finally, local staff also assist small foreign investors in dealing with the legal and regulatory conditions.[898]

According to interviewees, large firms are less likely to have a problem with predatory bureaucrats,[899] as they are likely to have the appropriate contacts and structures in place to pre-empt harassment. They will also benefit from being able to afford better lawyers.[900] Their contacts are likely to be of a political nature, and the larger the firm, the better the contacts. One investment promoter provides a colourful example:

> "If you're a major investment in Russia, the real way that you get everything to happen, is that you get a two minute meeting with Putin, or someone who can bend his ear in the presidential administration, or someone like [Moscow Mayor] Luzhkov – the 'big man', that's how the law gets done in Russia.
>
> We could spend hours debating about the nuances of the Russian Federation – rubbish! Let's be frank here, what's really going to make a difference in Russia today, and the Khodorkovsky thing can only underline this, is you've got to know the right big man. I remember speaking to a very big guy at [a tobacco company], who led into Russia, and we were having enormous problems, people were stealing truckloads of his cigarettes, and he got his CEO to meet Putin, and say, *'look Vladimir, if this carries on, we will take away our [multimillion dollar] investment in Russia'*, and I'm sure that's an empty threat, but the point is that once Putin made it known to all those people who worked in the regional ministry of economic development, goodbye to stealing cigarettes"[901]

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[896] Interviews FDI 1 (UK), FDI 6 (UK).
[897] Interviews FDI 9 (UK), FDI 1 (UK).
[898] Interview FDI 6 (UK), CON 3 (WE).
[899] Interview CON 5 (US).
[900] Interview CON 4 (RU).
[901] Interview PRO 3 (UK).

3.1.2 The Visibility of Large Foreign Investors

The visibility of western investors in Russia, especially large, publicly traded ones, is a significant issue. It can bring both advantages and disadvantages to firms' legal activities. According to the interviewees, the advantage that it brings is that such firms can and have used their status for attracting publicity and attention to instances in which their rights are being violated.[902] Large foreign investors, owing to their visibility and their stature, carry significant influence and clout.[903] As the last quote made clear, the largest foreign investors may well be able to get assurances from the highest political authorities.[904] This is considered a quite effective form of redress,[905] as it prompts a political intervention aimed at avoiding the undesirable negative publicity that such violations can generate. In fact, for exactly this reason, the investment strategy of the most high profile and vocal foreign portfolio investor relies on the principle of only investing in a Russian company if there is a public interest at stake.[906]

The disadvantage that large western foreign investors face in Russia is that, as they are expected to be "clean",[907] they cannot be seen to behave in particular ways. The need to preserve their international reputations may prevent them from engaging in "foul play techniques", in particular, in disputes with Russian counterparts.[908] In contrast, Russian firms are less likely to be constrained by this image factor.

Before proceeding, we need to be clearer about what is meant by "foul play techniques." Practices exist on a continuum, let's say, from mild to nasty. Using influential connections, gift giving or paying off government officials and judges, lie at the more palatable end of the scale; there is evidence, presented here as well as in

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902 Interviews FIN 2 (US), FIN 3 (RU), LAW 4 (EE) & BUS 5 (UK).
903 Interview LAW 2 (US).
904 Interview LAW 5 (US).
905 Interviews FIN 2 (US), LAW 4 (EE).
906 Interview FIN 2 (US).
907 Interview PRO 1 (UK).
908 Interviews FIN 2 (US), LAW 2 (US) & LAW 4 (EE).

Chapter Four,[909] that foreign investors use such tactics. However, there are other tactics that are known to occur in Russia that are much less palatable, though I have no indication of how commonplace they are today. For example, business rivals can militate numerous government bodies against one another, send death threats or occupy business premises by force. There was no evidence from the interviews in this study that foreign investors employed such practices, and we would have to consider it exceptional if foreign investors did resort to such extreme measures.

The preceding analyses refer therefore to the milder forms of dubious activity. I use the term 'dubious', because of the difficulty in drawing the line between legitimate and illegitimate forms of influence. For example, even western advisors questioned the impropriety of giving gifts,[910] and argued that fixing a value at which a licit gift becomes an illicit bribe was arbitrary.[911]

The point is that there are a range of informal activities that we can consider as feasible legal strategies for foreign investors, but which may be perceived as unacceptable by their shareholders and customers. The two following examples will suffice to make this point.

There is no evidence available that foreign investors have higher ethical standards and are constrained by these.[912] The issue is one of pragmatism, of putting a distance between themselves and practices that might be perceived as unacceptable. Thus Russia is replete with intermediaries that act as buffers between the investor and the proscribed act. For example, in regulatory spheres such as customs or licensing specialised agencies are employed to fulfil the requisite tasks. A part of their fee goes towards paying off the relevant officials.[913] In legal disputes, local lawyers are often

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909 See Chapter Four, subsection 3.1.

910 Interviews CON 2 (US), BUS 5 (UK)

911 Interview BUS 5 (UK)

912 In Chapter Four, subsection 4.1 World Bank evidence was presented that showed that foreign investors "were among the greatest beneficiaries of corruption in the region during the period."

913 Interviews FDI 3 (UK), FDI 9, FDI 10 (UK), BUS 2 (WE) & CON 5 (US).

brought in by western law firms, not for some legal expertise that they might possess, but because they are able to bribe judges.[914] Foreigners do not necessarily engage in such practices, but the point is that, concern for their reputation – which is the issue at stake here - need not prevent them from operating in the legal climate in a similar fashion to Russian firms.

This is only true up to a point, however. Respondents explained that foreign investors may have a lower tolerance for certain types of legal risks – either because of the need to uphold their international and domestic profiles, or because "mistakes come back to haunt you."[915] Such mistakes open the door for predatory bureaucrats and competitors to cause problems. Risks that may jeopardise an entire project include, for example, a "cockamamie tax scheme" or regulatory shortcut.[916] Therefore, it is in foreigners' long term interests, according to one lawyer, to opt to establish a good reputation in Russia and stick to that reputation, even if legal processes will take longer as a result.[917]

3.1.3 Medium Sized Firms

The literature shows that medium sized firms are caught somewhere between the two extremes.[918] They may neither be able to benefit from the inconspicuousness of small firms, nor from the influence of larger ones. Medium sized foreign firms face a dilemma – if they are growing and wish to raise further capital and expand, they must 'clean' their businesses, especially their tax affairs. This is what one British firm did.[919] It has also been the case that Russian entrepreneurs choose to diversify rather than continue to expand their businesses, as they do not wish to attract undesirable attention.[920]

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914 Interviews PRO 2 (UK), LAW 2 (US).
915 Interview LAW 5 (US).
916 Interview LAW 2 (US).
917 Interview PRO 1 (UK).
918 Batra *et al.* 2002, 49; Hewko 2002, 10; Perry 2001, 148-151.
919 Interview FDI 6 (UK).
920 Interview CON 5 (US).

3.2 Nationality, Culture and Mentality

There was no consensus about the impact of firm nationality. The greater share of respondents denied any trend,[921] for example, saying they had seen equal measures of success and failure.[922] Other respondents were sure that nationality mattered, but did not give specific examples.[923] Some respondents provide specific examples of how they expected national culture to affect perceptions of the legal climate: Americans were deemed to have a keener eye for the fine points of the law;[924] Asians, Italians, Germans, Turks and Indians were more comfortable in the Russian legal climate;[925] British investors were often characterised as being be particularly conservative.[926]

In suggesting that differences exist in foreign investors' attitudes to the legal climate according to their nationalities, one is really getting at whether investors can be classed according to their attitudinal differences towards the law, which may in turn be associated with nationality, as "our thinking is partly conditioned by national cultural factors."[927] In the words of one interviewee, "there are different *orthodoxies* of doing things in different countries."[928] In fact, a number of respondents argued that the true difference that set companies apart was not their nationalities so much but their company culture and management attitudes, which did in fact have an impact on their choice of legal strategies.[929] For instance, managers differ in the level of 'comfort' they require in a particular investment context, and the amount of risk they are prepared to take.[930] It was commonly felt that the best strategy for foreign

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921 Interviews CON 2 (US), LAW 2 (US), BUS 1 (RU), LAW 4 (EE), LAW 5 (US), LAW 6 (UK).

922 Interview LAW 4 (EE).

923 Interviews CON 1 (RU).

924 Interviews CON 2 (US), PRO 6 (RU).

925 Interviews CON 1 (RU) (Germans & Italians), PRO 6 (RU) (Asians & Germans), FDI 7 (UK) (Indians & Turks), PRO 1 (UK) (Italians & Germans).

926 Interviews FDI 2 (UK), PRO 3 (UK), FDI 8 (EE).

927 Hofstede 1983, 76.

928 Interview LAW 5 (US).

929 Interviews CON 1 (RU), BUS 1 (RU), LAW 4 (EE), LAW 5 (US).

930 Interview LAW 4 (EE).

investors was to adapt culturally, and 'go native'[931] such that even some large multinationals such as Kraft or Nestle are perceived as domestic firms.[932] Interestingly, Perry-Kessaris also found this to be true in India.[933]

A related firm characteristic which affects the impact of the law in the decision to invest is the previous experience of the potential foreign investor. One respondent puts the point across clearly:

> "It [their response to the Russian legal climate] depends on the company's philosophy, it depends to a large extent on how much business they're ready to do in emerging markets. If they're familiar with emerging markets, then there's nothing in Russia that will come as a surprise to them. For companies that have done business in China, in Bulgaria or Romania, for companies that are familiar with those markets, with Asia-Pacific markets, they're not going to be phased. Companies who have less familiarity dealing with emerging markets will of course have a greater problem."[934]

Other respondents agreed on this principle. [935] This echoes Wang's argument that foreign investors with previous experience of countries that lack the rule of law will fair better in China.[936]

Foreign investors that lack the requisite experience and approach will suffer. Respondents, both Russian and western, explained that foreign investors often do not grasp the flexibilities of the Russian legal climate. According to a Russian investment promoter, in Russia "the law is - you can use it in different ways"[937] Or, in the words of a senior British lawyer:

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931 Interviews CON 1 (RU), LAW 4 (EE), CON 3 (WE) & CON 5 (US).
932 Interview CON 1 (RU).
933 Perry-Kessaris 2005, 196.
934 Interview LAW 6 (UK).
935 Interviews FDI 2 (UK), PRO 3 (UK).
936 Wang 2001, 542-543.
937 Interview BUS 4 (RU).

> "someone once told me you could summarise all Russian law in one sentence 'You can do this unless a bureaucrat tells you, you can't; and you can't do this unless some bureaucrat tells you, you can.' That's still true to a certain extent."[938]

These quotes capture the degree of flexibility contained within the Russian legal climate, and reflect the point that a particular 'insight', especially of the "unwritten rules"[939] are indispensable to navigating it. Hence, even a Russian Minister responsible for investment policy complained that foreigners do not know how to do business and deal with the law in Russia.[940] So, some foreigners can be prejudiced by their own mentality[941] or lack of savvy.[942] A frustrated Russian investment promoter went further, arguing that legal problems are perceived, and with the right mentality, investors will realise that the legal challenges in Russia are "not really problems."[943]

3.3 Other Factors

3.3.1 External Standards

Foreign investors may also be constrained by the need to conform to express standards in their home countries. For example, the board of one German firm interviewed had signed up to a strict corporate governance code in the wake of the Enron scandal.[944] A lawyer cited a case where ambiguities in the legal situation were particularly uncomfortable for a major European investor, which, being publicly traded and audited, would have difficulty in reassuring its own institutional shareholders over its Russia plans.[945]

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938 Interview LAW 6 (UK).
939 Ledeneva 2001, 6.
940 Interview GOV 1 (RU).
941 Interviews CON 4 (RU), BUS 4 (RU).
942 Interview LAW 2 (US).
943 Interview BUS 4 (RU).
944 Interview FDI 4 (WE).
945 Interview LAW 5 (US).

3.3.2 The Role of Lawyers

The role of lawyers in larger firms with internal lawyers is also of note. In companies where lawyers are not integrated with the business development team, their concerns may be ignored. A lawyer explains:

> "You will often find the business guys saying, *'don't talk to the lawyers yet, they'll only make it too complicated.'* They want to flush out the entire opportunity. Lawyers complain that they are the last to know, and that they can't be that helpful if they only come in at the tail end. It depends on who is making the decision, and how that all plays out."[946]

3.3.3 Business Sector

In so far as the cost imposed by the legal climate and the gains available depend on the business sector, the impact of the legal climate will depend on the sector. Exposure to the legal climate and the regulatory burden varies between sectors,[947] as does politicisation[948] and corruption.[949] For example, as mentioned earlier, the very visibility of retail business compared to wholesale business brings with it an added degree of bureaucratic interference and corruption.[950] Equally, incentives to invest will also depend on the sector in question, with some sectors being more lucrative than others.[951] Thus the impact of the legal climate will depend on the sector in question, as the costs imposed by the legal climate must be weighed against the rewards of investing.

3.3.4 New Entrants vs. Established Investors

Finally, the interests of established foreign investors also differ from those of potential newcomers. Respondents agreed that regulatory obstacles serve as a barrier

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946 Interview LAW 5 (US).
947 Interviews PRO 3 (UK), LAW 4 (EE) & BUS 5 (UK).
948 Interview LAW 4 (EE), CON 4 (RU).
949 Interview LAW 4 (EE).
950 Interview FDI 1 (UK).
951 Interviews FIN 2 (US), PRO 3 (UK) & BUS 5 (UK).

to competition, and therefore, once a foreign investor has learned to manage these obstacles, they can serve as a competitive advantage as they hinder the entry of further competition.[952]

3.4 Conclusions

The interviews show that when talking about foreign investors and host legal climates, we must be careful not to over-generalise. Where they expressed an opinion on the matter, the majority of interviewees held that the perceptions and attitudes of incoming foreign investors towards the legal climate were not homogenous. Rather, it was felt that the impact of the Russian legal climate was contingent on a number of firm attributes. Size was the most widely held as important; sector was also verified by the interviewees; nationality received mixed opinions; the culture and experience of firms and their managers were also deemed to affect their attitudes to legal challenges. The law and development field has acknowledged the role of firm size in relation to domestic firms. It appears that the principle of firm characteristics has a wider application though, as this research shows that 'softer' characteristics such as company culture and experience, can variegate the impact of the host legal environment.

Interviewees confirmed Hypothesis Two, that "the impact of the Russian legal climate on foreign investors depends on their firms' characteristics." The findings suggest that it is not 'objective' assessments of the legal climate that inform and affect the decision to invest, but the subjective perceptions of the individual investor. The interviews also show that when considering the role of law in providing an attractive legal environment we should be aware that the nature of the legal climate and the institutions, laws and policies within it will have an uneven impact across the types of potential foreign investors; and so policies need to be more targeted towards particular types of firms.

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952 Interviews FDI 1 (UK), FDI 6 (UK), FDI 8 (EE).

It is possible to cautiously suggest some of the principles in action. The foreign investors' size, much like its domestic counterparts, affects the impact of the cost imposed by the legal climate and the nature of its relationship with the authorities. Larger firms can not only more comfortably afford the costs imposed by the legal climate, but their relationship with the state can be more positive than that experienced by small firms. The burden of regulations and taxation weighs more heavily on smaller firms. Moreover, they will not have the connections required to fend off predatory government officials, while large foreign investors will. Medium sized firms are caught in between these two poles. These findings echo the principles identified by existing literature about the differences between small and large firms.[953] As far as the question of culture is concerned, these interviews did not allow us to draw conclusions about which national cultures, if any, were more or less at ease with the Russian legal climate. Instead, the interviews showed that ways of thinking, expressed either at the national, corporate or management level, do make a difference to the perceptions of and approaches to the Russian legal climate.

Further research is required before one can assert more robustly how these characteristics may be expected to variegate the impact of the legal climate. Nevertheless, the very fact that foreign investors can differ substantially in their attitudes towards host legal climates, owing to these factors, is an important academic point. It shows that the sensitivity towards the quality of the host legal climate varies notably between foreign investors.

This Chapter has shown that the shortcomings of the Dominant Theory shortcomings lie in the fact that it only provides a partial explanation of the role of law, and thereby oversimplifying and the impact of the country's legal climate. Arguably the most useful way of interpreting this is simply by asserting that the relationship between foreign investors and host legal climates differs widely, and that there is strong evidence that a faction of investors do not conform to the Dominant Theory.

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953 See Chapter Four, subsection 4.1.

Chapter Nine

Conclusions

1 Summary of Research Approach

This study has examine and build on the Dominant Theory, that is, the importance of a Theoretically Ideal Legal Climate to the attraction and support of foreign investment into Russia around 2004. While this study accepts that the quality of the legal climate is relevant to a certain extent to foreign investors, it has argued that its importance has been overstated in the law and development field. This overemphasis on the importance of a Theoretically Ideal Legal Climate has led to a model of law and foreign investment which is incomplete, overlooking a range of factors. This study aimed to contribute to a more complete understanding of the impact of the quality of Russia's legal climate on foreign investment determination. Russia is an ideal testing ground for the Dominant Theory: it both lacks a Theoretically Ideal Legal Climate and has not received nearly enough foreign investment. In fact, many of the claims about the importance of a Theoretically Ideal Legal Climate to foreign investment have been made specifically about Russia.

1.1 The Dominant Theory and Theoretically Ideal Legal Climate

The Dominant Theory is the belief that a host country needs a Theoretically Ideal Legal Climate in order to attract and support foreign investors. Rather than the product of a few policy papers, the view is deeply rooted, widely held, and to the envy of many other theories, vigorously acted upon.

The Dominant Theory is built predominately on traditional law and economics. According to development institutions like the World Bank, the needs of the private sector must be addressed in order to encourage investment and economic growth. To support investors' needs, the legal system should provide a climate of predictability and low transaction costs. This entails, *inter alia*, an independent judiciary which efficiently and effectively enforces market-friendly laws, and a regulatory climate that is light-handed, transparent, stable and free from corruption. A Theoretically

Ideal Legal Climate is expected to provide investors with an unspecified yet satisfactory degree of certainty and efficiency in which to do business. A host country, like Russia, that generally lacks these features is considered to deter foreign investors.

The Dominant Theory derives from one of the central concepts in law and development, namely the importance of a Theoretically Ideal Legal Climate to economic development. While built around the principles of law and economics, this belief has also been influenced by the work of Max Weber, the scholarship of the law and development movement of the 1960's and 1970's, and further, the ancient heritage of the political rule of law, which runs back as far as the Magna Carta and Aristotle.

The Dominant Theory is labelled as such because it is propagated by multilateral institutions, such as the members of the World Bank Group and the OECD, foreign investment associations, such as FIAS and FIAC, as well as range of academic and commercial research bodies and politicians. Finally, the Dominant Theory is put into practise. The principle that a Theoretically Ideal Legal Climate is critical to economic development and foreign investment has motivated the expenditure of a great deal of time and hundreds of millions of dollars of public money on rule of law reform in the transition region. Moreover, foreign investors and their representatives have played a significant part in these reforms.

1.2 Limitations of the Dominant Theory

Given its theoretical bases, the support which it enjoys and its apparent logic, we must be careful and precise in our criticisms. It is clear that foreign investors *should* be attracted to high quality host legal climates, and conversely, that they *should* be deterred from hosts with poor legal climates. Further, it is clear that improvements in the quality of host legal climates would tend to have a positive effect on foreign

investment. But for a more complete understanding of law and foreign investment, we need to go further than tidy platitudes allow.

First of all, the Dominant Theory assumes that foreign investors are well informed about the quality of host legal climates, and further, that without a Theoretically Ideal Legal Climate, foreign investors are unable to operate successfully. In order to build on the Dominant Theory, it is necessary to test these assumptions. Second, the Dominant Theory does not make room for differences between investors. A more developed theory of law and foreign investment would incorporate systematic differences in attitudes towards the host legal climate. Third, there is little research on how foreign investors actually do business in host countries that they are meant to be deterred from. Again, an understanding of the impact of the host legal climate on their actual activities would contribute to a more complete model. The final shortcoming of the Dominant Theory is that those that propagate it almost never take into account the immense challenge of their prescription for foreign investment attraction – that of establishing a Theoretically Ideal Legal Climate. But one must at least acknowledge the challenge posed, and better yet, to make recommendations for foreign investment attraction that take this challenge into account.

2 The Evidence

2.1 Existing Research

Despite the common sense appeal of the Dominant Theory, there is a notable lack of robust direct evidence in support of it. The evidence that is available is of two types: the cross-country regression studies, and surveys of foreign investors. Both methods suffer from methodological limitations as well as inconsistent findings. Above all, neither actually directly address the question of the role of law in the decision to invest, but attempt to infer it indirectly. First, the regression studies on law as a determinant of FDI.

The application of the regression technique is not an appropriate tool for understanding the role of law in the foreign investment decision. To reiterate, it is indirect and so it cannot tell us about the actual role of the law in the decision to invest. Further, its use was shown to suffer from up to *ten* methodological problems. For instance, there are problems associated with estimating the quality of legal climates. Also, the regression technique cannot prove that the quality of host legal climates affected foreign investment, and moreover, may not even indicate such as the explanatory variables included in the model, such as the quality of the legal system, political stability, economic growth and so on, are not independent from one another.

At best, the results of the studies provide lukewarm support for a link between law and foreign investment, although not a direct causal one. What the studies indicate is that countries with certain better features of legal climates sometimes, though not always, enjoy more foreign investment. But, there is no way of telling whether that link is because another factor, such as economic growth, which is connected to both FDI and the quality of the legal climate, is at cause. Further, the results are often inconsistent. Thus, the regression evidence suggests that law may affect foreign investment decisions, though it certainly falls short of proving that the quality of host legal climates is of critical importance to foreign investment decision making.

The second body of research on law and foreign investment also comes with methodological flaws and confusing findings. Most of the surveys follow the same format: they ask current investors whether particular issues, especially legal ones, are perceived as obstacles to investment. Foreign investor surveys do indeed show that foreign investors prefer that host states possess features of a Theoretically Ideal Legal Climate. They also clearly show that foreign investors in Russia will complain about the lack of transparency of the regulatory climate, corruption, the effectiveness of the courts, problems with enforcing intellectual property rights, and so on. However, most of studies are, like the regression ones, too indirect - they do not even try to show that the perceived quality of host legal climates is actually a decisive factor in

the investment process. However, two of the three studies[954] that do address the role of law in the decision to invest provide evidence against the Dominant Theory.

Though they do not justify the extent and stridency of support for the Dominant Theory, the regression studies and surveys provide lukewarm, indirect support it. The evidence available suggests that the quality of legal climates may matter. Even if we believe that the quality of the host legal climate is very important, we cannot make a stronger assertion without verifying two assumptions about foreign investor behaviour: first, about how well informed they are about host legal climates; and second, about how potential foreign investors react to information that a host legal climate is weak. It is perhaps the questions that the evidence does not answer that can glean the most insight:

1. How do foreign firms perceive host legal climates prior to investment?
2. Why do foreign investors invest in spite of an apparently critical view of the legal climate?
3. What firm characteristics make legal issues more or less of a barrier to investment?

This research study has attempted to address these within the parameters of the two hypotheses.

2.2 Building on The Dominant Theory

Hypothesis One was that "a Theoretically Ideal Legal Climate is not always necessary to support foreign investors in Russia." Three reasons in support of Hypothesis One were identified by the interviewees; these were consistent with the findings of the literature reviewed in Chapter Four. The first two reasons are that, to the knowledge of the interviewees during the period under study, perceptions of the

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954 Hewko 2002, Perry 2001; the other is Klavens & Zamparutti 1995

legal climate were not a decisive factor in the decision to invest in Russia. In other words, foreign investors neither chose nor rejected Russia on the basis of their perceptions of its legal climate.

The Dominant Theory presumes that foreign investors have accurate information about host legal climates. But according to the interviewees, at the preliminary stage when they are considering Russia as a possible host, potential foreign investors do not have accurate information about the legal climate. Fuelled by the media and public perceptions, inaccurate, generalised and stereotyped opinions deter many foreign firms from even considering a potential investment in Russia. Even companies that have gone as far as talking to investment promoters and lawyers can be quite ignorant about Russia and hold exaggerated fears. Further, potential investors at this stage, do not view the legal climate as a discernable issue. Instead, their impressions of Russia's investment climate are formed by broader economic and political trends, and news making events.

A range of evidence corroborates and adds credibility to these findings. Within the FDI literature, the works of Perry-Kessaris and Hewko also show that, when choosing a host, foreign investors do not refer to accurate information about legal climates. The findings are also consistent with those of behavioural decision analysis, which explains why economic actors may not be able to acquire and process accurate information about host legal systems and legal risk in the rational manner supposed. One salient example is that major news making events can distort perceptions of what is important. Bounded rationality also predicts that foreign investors might use rules of thumb to simplify in their decisions: both the present study and the one conducted by the Foreign Investment Advisory Council of Russia (FIAC) show that general trends in Russia, and the appearance of the right policies being taken, had a greater impact on investors' decisions than the perceived weakness of its legal

climate.[955] Finally, the findings reassert the point that the image of Russia abroad is a pressing foreign investment issue.

The Dominant Theory also presumes that foreign investors will be deterred by a host that lacks a Theoretically Ideal Legal Climate. But the interviewees showed, in support of Hypothesis One, that the accurate information which foreign investors gather about the Russian legal climate once they have started to consider an investment opportunity there, does not put them off. This is because foreign investors only examine the legal climate in depth once they have already decided that a business case exists for an investment. According to the interviews, it is rare that they will abandon the opportunity because of what they then learn about the legal climate. Further, foreign investors already come into Russia knowing that the legal climate is poor; in fact, they may even be relieved by what their advisors tell them about the legal climate. Thus perceptions of the host legal climate do not appear to have a decisive role in investment process. This is consistent with the Eclectic Paradigm, the prevailing theory of foreign investment determination, which shows that the legal climate is not a decisive factor in the choice to invest abroad.

The final reason why the absence of a Theoretically Ideal Legal Climate may not prevent foreigners from investing is that a Theoretically Ideal Legal Climate is not always required to support them. Interviews described ways in which the legal risks of entering and operating in Russia can be managed. Prior to actually investing, foreigners can open a low-cost 'representative office' to assess the opportunities and risks of investing more thoroughly. Foreign investors also tend to defer responsibility for day to day legal issues to joint venture partners, local employees, accountants and lawyers. Perry-Kessaris also found that foreign investors in India rely on locals for day-to-day bureaucratic and legal affairs.[956] Finally, their lawyers will offer ways in which specific legal risks can be managed. For example, contract enforcement risk can be reduced by the detail and manner in which contract provisions are made.

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955 See Chapter Three, Section 2.

956 Perry-Kessaris 2005, 176.

The interviews showed that the key to success in Russia was adaptation to the legal strategies that were known to work there. This means that success rests upon making use of both formal procedures and informal tactics, often in conjunction. Foreign investors must abide by the law, and be as thorough as possible, not so much for reasons of principle, but because Russia has a "very unforgiving legal climate."[957] At the same time, however, they must be prepared to seek solutions by relying on influential connections (the 'krysha' or roof), fostering cordial relations with government officials, and also bribery, which may in some cases involve payment to law enforcers to actually carry out their jobs effectively!

As far as I am aware, this is the first study to look closely at the legal strategies that foreign investors use to cope in Russia's legal climate. The interview findings corroborate existing research, reviewed in Chapter Four, about how alternatives to a Theoretically Ideal Legal Climate enable foreign investors to do business successfully. Wang and Hewko also argue that informal system were used by foreign investors to compensate for the inadequacies of the state legal system in China and transition countries, respectively. The World Bank found that foreign investors in transition countries benefited from corrupt practices.[958]

By demonstrating how foreign investors cope in Russia's weak legal climate, this study shows that the surveys which enumerate and bemoan legal obstacles to business can exaggerate the importance of the law to investors, and present a one-sided picture of the relationship between foreign investors and host legal climates. The interview findings help us to understand some of the paradoxes in existing research. A good example is the 2005 FIAC survey of 107 foreign investors in Russia, and 51 potential investors. The study found that the legal and regulatory climate stood out as the most significant obstacle to business. This is precisely the type of evidence the Dominant Theory relies upon. However, the vast majority of current

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957 Interview LAW 5 (US).

958 See Chapter Four, Section 3.1.

investors surveyed were planning on increasing their investments, while most potential investors had plans to invest in Russia.[959] Foreign investors, we conclude, must be finding ways of doing business successfully in spite of these legal shortcomings.

A similar example can be found in the contrasting findings of the BEEPS. In the analysis of the BEEPS in Chapter Five, foreign investors described the Russian legal climate as very poor, but they did not perceive its actual impact on their businesses to be nearly as bad. To illustrate, while over 80% of foreign investors held negative views about the honesty of the courts, 73% felt that the courts were either no obstacle or a minor obstacle to their business. This study explains these discrepancies by showing how foreign investors can either take advantage of the dishonesty of the courts or at least work around them.

The Dominant Theory assumes that all foreign investors are alike in their sensitivity towards the quality of host legal climates. The second Hypothesis was that "foreign investors' perceptions of the Russian legal climate depend on their firm characteristics." Confirming the hypothesis, a strong current throughout the interviews was that foreign investors' perceptions of the Russian legal climate and their ways of dealing with it depended significantly on the circumstances of the investor and investment.

In the context of the decision to invest, it was found that smaller firms were more put off than larger firms by public perceptions of Russia as well as the costs of investigating and entering the country. On the other hand, larger firms with more resources could afford to research and consult on the Russian investment climate more thoroughly. Moreover, large foreign investors, including some of the interviewees, can get assistance from senior government officials such as the Moscow Mayor, the Minister for Economic Development or even the President.

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959 See Chapter Three, Section 2.

The notion that small firms are more prejudiced by challenging legal climates is a common one in law and development literature.[960] Research on foreign investors demonstrates differences according to size, but owing the shortage of research, no clear trends can be identified as yet. The findings here support the ideas of Vandevelde, who argues that states seeking to attract more risk averse investors, such as small firms with limited resources, would benefit the most from reducing the investment risk.[961]

Once inside Russia, firm characteristics also have a great effect on a foreign investors' relationship with the legal climate. As expected, firm size is a crucial variable. The constructiveness of their relationship with the state, and their capacity to shoulder the costs of the legal and regulatory environment sets small and large foreign investors apart. Smaller ones are advised to avoid the legal system as much as possible, while larger firms should rely on good lawyers and even better connections with the authorities. These findings are supported by existing work on how firm size affects the impact of legal climates. For example, studies have reported that smaller domestic firms are more harmed by corruption, and benefit more judicial efficiency and property rights protection. [962]

In addition to firm size, firm sector was identified as an influential variable. This is because sector which a firm operates is important in determining the rewards available to investors and the scale of regulation and corruption that they face. Little was said about the impact of joint ventures.

Wang and Hewko argue that investors who are used to dealing with unpredictable and weak legal climates in their own countries would be advantaged in host countries with similar features.[963] The interviewees did not provide a consensus on how national culture played a part, but they were united in asserting that experience

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960 Chapter Two, Section 4.1.
961 Vandevelde 1998, 526.
962 See Chapter Four, Section 4.1.
963 Hewko 2002, 6; Wang 2001, 542-543.

and management attitudes significantly affected how well foreigners fare in the legal environment. The reason for this was that these factors affect the ability of foreign investors to adapt to the Russian legal climate. And the quicker they learn that in Russia "the law is - you can use it in different ways"[964], the better they will fare.

2.3 Conclusions

Both Hypotheses were confirmed. The findings relating to Hypothesis One contribute to the argument that the Dominant Theory only provides a partial explanation of the relationship between foreign investors and host legal climates. This limitation results in a tendency to overstate the impact of legal obstacles on businesses and generally oversimplify the role of the legal climate, as perceived by foreign investors in Russia. A legal climate that is not ideal may still be workable. Thus, while a legal climate bearing a greater resemblance to a Theoretically Ideal Legal Climate is no doubt preferable for foreign investors in Russia, we cannot assert with confidence how important it really is, and certainly stop short of claiming it is 'necessary'. Perhaps one gains the most mileage in this debate by emphasising that the importance attached to the legal climate depends on the type of investor. This is the issue discussed in greater detail under the second Hypothesis.

The Dominant Theory does not account for differences in attitudes towards legal climates. But a major conclusion of this research is that the impact of the Russian legal climate depends on the foreign investor's own characteristics. Further research is required to claim more confidently exactly how firm characteristics affect foreign investors' relationships with host legal climates. Nevertheless, the very fact that foreign investors differ substantially in their attitudes towards host legal climates is a notable point. This stems from the principle that risks are perceived and subjective, and so we should expect differences between firms.

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964 Interview BUS 4 (RU).

To conclude, the evidence shows that a notable faction of foreign investors in Russia circa 2004 do not conform to the Dominant Theory, although we have no information about what proportion of foreign investors this faction represents, including those that 'got away'. What is clear, however, is that foreign investors' attitudes and responses to host legal climates contain subjective element that should not be overlooked.

3 Discussion

The research study started with the question of law as a determinant of FDI, which is an important and current issue in law and development, particularly in the case of Russia. One issue that arose was that of Russia's image abroad, which is a key challenge for foreign investment promotion. But beyond that, to generate a deeper understanding of the relationship between foreign investors and host legal climates, this study has addressed emerging issues, namely: the legal activities of foreign investors in Russia, including informal institutions and bribery, and also the role of firm characteristics. To provide a more rounded analysis of the Dominant Theory, one must also address the issue of the feasibility of legal reform. Having raised the issue of the role of law in development, we see similarities in the Dominant Theory and the prevailing approach to legal reform. And so finally, this study touches briefly on the importance of interdisciplinarity and context in research and practise in these fields. These issues will be addressed in turn in the subsections that follow.

3.1 Law as a Determinant of Foreign Investment

The Eclectic Paradigm demonstrates that the decision to invest depends on numerous factors. The key ones amongst them, and this is supported by research in the transition region, are economic incentives. The interviewees also made the point that the business decision comes first. The extent to which the legal climate acts, in the long term, to create attractive economic opportunities is an central question in law and development, but beyond the scope of the present study.

Within the scope of the investment decision, what role does the quality of the legal climate play? In countries like Russia, essentially, it acts as fence, or a barrier, which may or may not deter investors from pursuing an investment opportunity further. The legal climate, is not, however, the incentive itself. When may the legal climate act as a barrier? When, the quality is perceived on the part of the potential investor to be below what they consider to be an acceptable minimum standard; or in other words, when they perceive the risks to outweigh the benefits.

Looking at the investment as a risk-reward calculation provides simplicity and clarity. As the economic incentives increase, the relative weight of legal risk, in principle, decreases. Equally, as the legal climate improves, it becomes more widely acceptable to potential investors, and therefore deters fewer potential foreign investors. How foreign investors come to learn that the legal climate has improved is an important question that shall be addressed in next subsection. Though a legal climate may not be Theoretically Ideal, at some point, it may no longer serve as an effective barrier to investment. This will depend on the economic incentives for investment, other barriers, and also competition from host states.

Michalet studies the attitudes of multinational investors in the transition region and competition between host states.[965] He holds that international investors viewed countries as either being on a priority short-list of investment destinations or in the bracket of 'potential' hosts. According to Michalet, there is little trade-off between short-list countries, as firms want to have a presence in all of the core countries,[966] while 'potential' hosts did not yet meet the necessary conditions to attract investment from the firms surveyed. To illustrate: if Russia and Poland are both on the short-list, then Russia competes with Poland. In that case, one reason why it does not receive as much FDI may be because the Polish legal climate is better than the Russian one. However, if Russia is not yet on the short-list, while Poland is, then the difference in the quality of their legal climates is immaterial. Hence the role of law is 'relative' in

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965 Section 4.4.2.

966 Michalet 1997, 3.

the sense that within the context of the investment decision, *ceteris paribus*, law matters only in so far as how one country's legal climate measures against its FDI rivals.

3.2 The Importance of Image

One major implication of this study concerns foreign investment attraction and the importance of improving Russia's image abroad. The idea of 'changing Russia's face' has in fact frequently been tabled in foreign investment policy circles. For example, in 2003, the President commissioned the Prime Minister, Foreign Minister and Minister for Economic Development, to take measures to improve Russia's image abroad for the sake of attracting foreign investment;[967] in 2004, he instructed Russian ambassadors to do the same.[968] The Foreign Investment Advisory Council has a Working Group dedicated to the investment image of Russia.[969]

According to members of the Foreign Investment Advisory Council of Russia, myths about Russia need to be dispelled and awareness spread that economic and political risk is diminishing. This partly requires an informational and media campaign, but more importantly, it depends on foreign businessmen actually seeing first hand how business is done there.[970] An effective way of spending resources, according to the chairman of the European Business Club, would be to renovate Moscow's main airport, Sheremetyevo, which is allegedly "the main source of the negative image of Russia for people coming to Moscow."[971] In fact, the country recently embarked on an overseas public relations which includes trips for foreign journalists and politicians, an English-language television channel, and an annual winter festival in London.[972] However, while public relations strategies may help to gradually improve

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967 The Russia Journal 2003.
968 The Moscow Times 2004b.
969 FIAC Internet Site.
970 The Moscow Times 2004c.
971 Remmes 2002, 6.
972 The Economist 2006.

foreigners' perceptions of the investment environment, setbacks such as the Yukos affair and the Beslan tragedy can quickly nullify the effect of progress, especially as Russia already carries a burden of stereotyping. Some argue that image building can only achieve so much, for "even if image makers make wonders", without true reform, "the illusions will disappear, sooner or later."[973]

3.3 A Broader Model of Law and Foreign Investors

Future research on law and foreign investors should take a broader perspective than it has in the past. To improve the Dominant Theory as a theory of law and foreign investment, it should take into account what has been learned about the actual impact of the Russian legal climate on foreign investors.

First, instead of presuming that foreign investors make objectively rational decisions based on full information, the Dominant Theory can benefit from the field of behavioural law and economics. The field lends a theoretical framework for understanding the limitations in foreign investors' ability to acquire and process accurate information about host legal climates. This is particularly important for a country like Russia which suffers from stereotypes.

Secondly, researchers in the field of law and development should place legal factors in wider context. A law-centred focus inevitably overemphasises the role of law. On the question of foreign investment determination, a contextualised approach would attempt to assess the impact of law on foreign investors alongside the numerous other factors that affect firms' decisions.

Third, instead of assuming that only a Theoretically Ideal Legal Climate can provide investors with their desired level of efficiency and predictability, researchers should pay greater attention to alternatives to Theoretically Ideal Legal Climates. Further

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973 The Russia Journal 2003.

research on how foreign investors do business in Russia's legal climate would tell us more about the 'necessity' of a Theoretically Ideal Legal Climate and also extend core issues in transitional law and development, such as the relationship between the firm and state, informality, corruption, and firm characteristics, to the study of foreign investors. Research on how firms cope would also help to distinguish between legal sectors that are satisfactory and those which, in the eyes of foreign investors, are priorities for reform.

Fourth, instead of presuming the impact of the law to be uniform, the Dominant Theory should recognise that the impact of the law, both in the decision to invest, and during operations, depends on the investor and investment in question. The importance of firm characteristics has relevance for future research as well as for policy-making. The results presented in this study are preliminary, and it would useful to repeat them on a broader scale in order to ascertain trends. Statistical analysis of surveys such as the BEEPS would add robustness to the qualitative findings here. Ideally, policy-makers would be able to target strategies for the attraction and support of foreign investors according to their needs. For example, smaller investors may receive greater assistance with regulatory and taxation issues.

Finally, legal climates should not be treated as a single homogenous entity. Surveys that assess perceptions of the legal climate distinguish between the numerous aspects of the legal climate, from tax administration, to customs, to the courts, to corruption, to inspections and licensing. In Russia's case, according to the literature reviewed in Chapter Five, the most important challenges are not the courts, and not so much corruption, but above all the (un)predictability and (in)efficiency of the regulatory environment and the arbitrary behaviour of government officials. In the past, advocates of the Dominant Theory have tended to overemphasise the role of the courts.

3.4 The Role of Law in Development

The perennial question in law and development is whether there is a single legal climate best suited to economic development. As far as foreign investment in Russia in the period under study is concerned, the evidence suggests 'not necessarily'. Foreign investors can adapt, cope and prosper in Russia. Naturally, improvements in the legal climate would bring benefits and increase foreign investment flows; this is undeniable, and so legal reform must continue. At the same time, however, establishing the rule of law in Russia, as Chapter Six showed, is an immensely difficult challenge that may take a generation or longer. So, while a Theoretically Ideal Legal Climate may be theoretically and ideally desirable, in practise, one has to accept the real world challenges of implementation, and in the near term, aim for a workable legal climate that meets an acceptable minimum standard instead.

3.5 Parallels Between The Dominant Theory and The Rule of Law Orthodoxy

The Dominant Theory and the rule of law orthodoxy are two expressions of a single belief: one in the importance of formal legal systems in the determination of economic behaviour, and further, in the efficacy of legal reforms in spurring economic development, including domestic and foreign investment. This subsection analyses the interesting parallels between the Dominant Theory and the rule of law orthodoxy. These views tend to aggrandize the role of law in development, whilst much of the evidence in the literature and fieldwork stresses the limitations of the role for formal legal systems in the present context. There are five parallels.

First and foremost, the importance attached to the quality of formal legal by both the Dominant Theory and the rule of law orthodoxy. Both approaches assume that law is a vital determinant of economic behaviour. The transition reform approach held law as an instrumental force that can be manipulated to govern behaviour,[974] and so it was assumed that the right laws would be automatically enforced and produce the anticipated changes. This belief in the impact of legislative change on the behaviour

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974 Burg 1977, 505; Campbell and Piccioto 1998, 250

of economic actors is mirrored by the central position the legal system in general is given in the decision to invest in a foreign country. But legal reforms in transition lacked effectiveness and produced unintended consequences. Similarly, the interviews showed that the role of law in the decision to invest may sometimes be very limited. So, perhaps law is not as crucial in directing economic behaviour as it is sometimes believed to be.

The efficacy ascribed to law derives from viewing law in the abstract rather than in practice. To some, the collapse of Communism was an opportunity to design "intricate models of theoretical perfectionism."[975] This was part of a mechanical view of cause and effect which was divorced from any empirical investigation of how laws were being used.[976] Similarly, the Dominant Theory is partly built on abstract presumptions about the investment decision process; it also suffers from a lack of direct empirical foundation. When one examines economic actors' perceptions of the law directly, it becomes clear that sometimes, foreign investors may overlook legal systems in the decision to invest, while foreign and domestic firms in transition often avoid and abuse legal systems.

Not only does the prevailing view not refer to how laws are actually perceived and responded to, but moreover, it does not view law in its wider context. For example, Upham claims that the rule of law orthodoxy overlooks the "truth" that law is "deeply contextual."[977] According to the World Bank itself, country conditions were not adequately reviewed before loans, stipulated on legal reform, were made in the region.[978] In law-and-FDI, the context referred to is the decision to invest and the various factors that influence it. Dunning's Eclectic Paradigm, which is a comprehensive framework, gives law a minor role in the choice of host. In this research, it was learned that business opportunities take precedence in the minds of investors, and perceived legal challenges can be responded to. Therefore, the role of

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975 Waelde and Gunderson 1994, 376
976 Hendley 2004, 608-611
977 Upham 2002, 7
978 Gupta *et al.* 2002, 7-8

law diminishes considerably when one actually integrates it into the wider context in which it exists.

The fourth parallel in Dominant Theory and rule of law orthodoxy is the view of economic actors as homo-economicus. For instance, in the context of privatisation, western economists argued that "there was no 'Soviet man,' only 'economic man,'" who, once given property rights, would create an "irresistible" lobby for the rule of law.[979] History tells another story. In the law-and-FDI sphere the presumed classical 'rationality' of economic actors is put to question by behavioural decision theories, which this research corroborates. For instance, investors were often found to be swayed by superficial information about Russia and analyse the country by utilising heuristics. This is inline with other work in the FDI field.[980] Moreover, far from being homogenous, foreign investors and economic actors differ sharply in their attitudes and approach to legal climates. In summary, the impact of the law is not absolute. Instead, the perceptions of economic actors are subjective in principle and can deviate from what classical law and economics considers 'rational'.

The final similarity in the two dominant views is the overemphasis on the role of formal institutions with the corresponding neglect of informal ones. As already mentioned, transition legal reforms have been characterised as technocratic and ungrounded. Once informal institutions are taken into consideration, however, one learns that they constrain the effectiveness of reforms. For instance, informal institutions are resistant to change, and policy levers cannot generally penetrate them. Informal institutions also affect the demand for reform.[981] Similarly, the Dominant Theory does not account for the role of informal institutions in transition economies. In so far as they pervade such climates and serve as a substitute for formal systems, informal institutions explain why the existence of high quality formal legal systems may not always be necessary to foreign investors. This research

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979 Hoff & Stiglitz 2004, 15

980 Hewko 2002 and Perry-Kessaris 2001

981 See Chapter Five, Section 3.3

showed that foreign investors do indeed rely on informal practices in Russia; similarly, Wang's work demonstrates the importance of Chinese informal networks in supporting foreign investors there.[982]

3.6 The Importance of Context and Interdisciplinary Knowledge

It is not being argued that traditional law and economics has nothing to offer, or that its principles are mistaken. On the contrary, it provides ideal theoretical starting point, instructing us about how economic actors should behave. But it cannot fully account for how legal climates are perceived, used, abused and avoided by foreign investors in countries like Russia. This is why the Dominant Theory has been found to lack some accuracy.

Scholars such as Robert Ellickson, David Campbell and Sol Piccioto have also argued that law and economics has been held back by the assumptions of economics, and that progress requires understanding the broader social context of economic activity.[983] North and Coase also took issue with the behavioural assumptions of classical economics.[984] In the future, work and policy on law in transition must be more grounded in the empirical realities of legal practices, and also be more interdisciplinary, giving recognition to the variety of influences that shape economic behaviour.

Transition legal reforms did not work out the way intended as they did not adequately account for how law functioned in society, as well as the numerous legal, social, political and historical influences on rule of law reform. To avoid the mistakes of the past, research and reforms must be both interdisciplinary and grounded in an understanding of how law is actually used and misused. A leading researcher of law in Russia, Kathryn Hendley is firmly of the view that societal attitudes to law and the

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982 Wang 2000

983 See Campbell and Piccioto 1998, Ellickson 1998.

984 See Chapter Two, subsection 2.1

way in which laws are used, including the role of informal practices, are essential to legal study and legal reform.[985]

According to Garth the study of 'law in context' was in part a response to the criticism of the law and development movement.[986] One of the advocates of law in context is William Twining. Twining is firmly in favour of an interdisciplinary understanding of law. His conception of law in context involves the breaking down of the "rigid barriers" between fields of study.[987] His book, "Law in Context" is subtitled, "Enlarging a Discipline". While legal reforms have been dominated by traditional law and economics, Twining's approach is more pluralistic. Context and breadth, he says, "involve multiple lenses, historical, geographical, ethical, logical, sociological and so on. The basic commitment is...to advancing and disseminating understanding."[988] In short, Twining believes that "breadth of vision" is required to understand the role of law.[989] This research study shares his belief.

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985 Hendley 2004, 608-611 and 615-616.
986 Garth 2000, 6.
987 Twining 1997, 24.
988 Twining 1997, 25.
989 Twining 1997, 25.

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